SECURITIES AND EXCHANGE COMMISSION

This file is maintained pursuant to the Freedom of Information Act (5 U.S.C. 552). It contains a copy of each decision, order, rule or similar action of the Commission, for **December 2009,** with respect to which the final votes of individual Members of the Commission are required to be made available for public inspection pursuant to the provisions of that Act.

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

MARY L. SCHAPIRO, CHAIRMAN

KATHLEEN L. CASEY, COMMISSIONER

ELISSE B. WALTER, COMMISSIONER

LUIS A. AGUILAR, COMMISSIONER

TROY A. PAREDES, COMMISSIONER

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

June 2, 2009

IN THE MATTER OF PATRIOT ENERGY CORP. File No. 500-1	:	ORDER OF SUSPENSION OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Patriot Energy Corporation because of questions regarding the accuracy of assertions by Patriot Energy Corporation in press releases to investors concerning, among other things: (1) the company's business agreements and (2) a tender offer for Patriot Energy Corporation's outstanding shares.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of Patriot Energy Corp.

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities Patriot Energy Corp. is suspended for the period from 9:30 a.m. EDT on June 2, 2009, through 11:59 p.m. EDT, on June 15, 2009.

By the Commission.

Elizabeth M. Murphy
Secretary

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

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Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61096 / December 2, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13702

In the Matter of **Bruce B. Blatman,** **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 Bruce B. Blatman ("Blatman").

II.

In anticipation of the institution of these proceedings, Blatman 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 finding contained in Section III.2 below, which are admitted, Blatman 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 Blatman's Offer, the Commission finds that:

1. Blatman was the president, from May 2007 until May 2008, of North American Clearing, Inc. ("North American"), a general securities and clearing brokerage firm registered with the Commission. Blatman, 53, is a resident of Oviedo, Florida.

2. On November 13, 2009, a judgment was entered by consent against Blatman, permanently enjoining him from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; aiding and abetting future violations of Section 15(c)(3) of the Exchange Act and Rule 15c3-3 thereunder; and aiding and abetting future violations of Section 17(a) of the Exchange Act and Rule 17a-3 thereunder, in the civil action entitled Securities and Exchange Commission v. North American Clearing, Inc., et al., Civil Action Number 6:08-cv-829-ORL-35KRS, in the United States District Court for the Middle District of Florida.

3. The Commission's complaint alleged that North American encountered a financial crisis, and in order to continue operating North American, the Defendants, including Blatman, engaged in a series of unauthorized and fraudulent transactions designed to gain access to client funds to pay North American's operating expenses. The complaint also alleged that North American conducted securities business without maintaining the required amount of customer protection reserves and failed to maintain accurate books and records.

IV.

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

Accordingly, it is hereby ORDERED:

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

Any reapplication for association by Blatman 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 Blatman, 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.

Elizabeth M. Murphy
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. 61109 / December 3, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-12896

In the Matter of **FOUNDING PARTNERS CAPITAL MANAGEMENT COMPANY and WILLIAM GUNLICKS,** Respondents.	Order Directing Disbursement of Disgorgement Fund

On March 3, 2008, the United States Securities and Exchange Commission issued a Notice of Proposed Plan of Distribution and Opportunity for Comment (Exchange Act Rel. No. 57423). The Notice advised that all persons could obtain a copy of the Distribution Plan at www.sec.gov and submit any comments on the Distribution Plan, in writing, no later than April 2, 2008. The Commission received no comments and on May 9, 2008 issued an Order Approving Distribution Plan and Appointing Fund Administrator (Exchange Act Rel. No. 57807).

The Distribution Plan provides that the Fund Administrator will develop a list of payees and amounts and then seek an order directing disbursement for the distribution based upon this payee list. The distribution to Eligible Limited Partners and successors will be implemented by the Financial Management Service, United States Treasury, which will cut checks or electronically transfer funds to each payee as instructed by the Fund Administrator. The Fund Administrator has developed a list of 54 payees, totaling $176,637.93, and all information required to make the distribution.

Accordingly, it is ORDERED that the $176,637.93 in the Disgorgement Fund be disbursed as provided for in the Distribution Plan.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61111 / December 4, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13703

In the Matter of DAVID GOLD, 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 David Gold ("Gold" 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:

1. Gold, age 43, operated a branch office of J.S. Securities, Inc. ("JSSI") that was located in Westbury, New York In August 1996, the NASD barred Gold from associating with any member firm for failure to testify and answer questions concerning allegations that an imposter had taken the Series 7 examination on Gold's behalf. Although Gold was not a registered principal or registered representative at JSSI, he acted as a broker and arranged the sale of common stock of Securitek International, Inc. ("Securitek") to retail investors.

2. On November 2, 2009, a final judgment was entered by consent against Gold in the civil action entitled Securities and Exchange Commission v. Szur, et al., 97 Civ. 9305 (LAP), in the United States District Court for the Southern District of New York, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Sections 10(b) and 15(a)(1) of the Exchange Act and Rule 10b-5 thereunder, and barring Gold from participating in any penny stock offering.

3. In the civil injunctive action described above, the Commission's amended complaint alleges, among other things:

From approximately January through August 1996 Jeffrey Szur and Bertram Slutsky directed a scheme to manipulate the market for securities issued by Securitek. Slutsky paid undisclosed bribes to Szur and JSSI employees, including Gold, of up to 50% of the proceeds of the sale of Securitek stock to unsuspecting retail customers. These bribes enabled Slutsky and his companion, Diane Larkin, to sell their large block of Securitek stock into an artificially pumped up market. Gold helped operate a JSSI branch office in Westbury, New York, which operated as a boiler room where registered and unregistered salespersons engaged in fraudulent, high-pressure sales tactics in the offer and sale of Securitek stock to retail customers.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Gold 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.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61118 / December 4, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-12111

In the Matter of Federated Investment Management Company, Federated Securities Corp. and Federated Shareholder Services Company, Respondents.	NOTICE OF PROPOSED PLAN OF DISTRIBUTION AND OPPORTUNITY FOR COMMENT

Notice is hereby given, pursuant to Rule 1103 of the Securities and Exchange Commission's ("Commission") Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1103, that the Division of Enforcement has filed with the Commission the proposed plan ("Distribution Plan") for the distribution of the Fair Fund pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002 in In the Matter of Federated Investment Management Company, Federated Securities Corp. and Federated Shareholder Services Company ("Federated"). The Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b)(4) and 17A(c)(3) of the Securities Exchange Act of 1934, Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940 as to Federated Investment Management Company, Federated Securities Corp. and Federated Shareholder Services Company, Administrative Proceeding File No. 3-12111 on November 28, 2005. (Rel. No. 34-52839)

OPPORTUNITY FOR COMMENT

Pursuant to this Notice, all interested parties are advised that they may obtain a copy of the Distribution Plan from the Commission's public website, http://www.sec.gov, or by submitting a written request to Elaine C. Greenberg, Associate Regional Director, United

States Securities and Exchange Commission, 701 Market Street, Suite 2000, Philadelphia, PA 19106. Further, all persons desiring to comment on the Distribution Plan may submit their comments, in writing, no later than 30 days from the date of this Notice:

1. to the Office of the Secretary, United States Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090;

2. by using the Commission's Internet comment form (http://www.sec.gov/litigation/admin.shtml); or

3. by sending an e-mail to rule-comments@sec.gov.

Comments submitted by e-mail or via the Commission's website should include "Administrative File Number 3-12111" in the subject line. Comments received will be available to the public. Persons should only submit information that they wish to make publicly available.

THE DISTRIBUTION PLAN

The Distribution Plan provides for distribution of the Fair Fund which consists of disgorgement of $27 million and a civil money penalty of $45 million, plus any accumulated interest, less any federal, state, or local taxes on the interest. The Distribution Plan provides for distribution of the Fair Fund to eligible investors in the Federated Funds identified in the plan to compensate them for losses resulting from market timing and late trading. If the Distribution Plan is approved, eligible investors will receive a proportionate share of the Fair Fund as calculated by the Independent Distribution Consultant. The distribution amount will be calculated from information in Federated's records, and records obtained from third-party intermediaries. Eligible investors will not need to go through a claims process.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61113 / December 4, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3072 / December 4, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13704

In the Matter of **ROBERT BERNSTEIN,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Robert Bernstein ("Respondent" or "Bernstein") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

[1] Rule 102(e)(3)(i) provides, in relevant part, that:

> The Commission, with due regard to the public interest and without preliminary hearing, may, by order . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III(3) below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Bernstein, age 44, passed the CPA exam in New York but does not have a license to practice accounting in any state. He served as controller of American Home Mortgage Investment Corp. ("AHM" or the "Company") from December 2002 until June 2008.

2. AHM is a Maryland corporation headquartered in Melville, New York. In 2006, AHM was one of the nation's largest home mortgage lenders. AHM's common and preferred stock was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act"). Through the first quarter of 2007, AHM filed periodic reports, including Forms 10-K and 10-Q, with the Commission pursuant to Section 13(a) of the Exchange Act and related rules thereunder. Since May 10, 2007, the Company has not filed any required periodic reports. On August 6, 2007, AHM and its direct and indirect subsidiaries filed for bankruptcy protection. On February 23, 2009, the Bankruptcy Court confirmed AHM's plan of liquidation.

3. On April 28, 2009 the Commission filed a complaint against Bernstein and others in SEC v. Strauss, et al. (09 Civ. 4150) (S.D.N.Y.). On November 17, 2009, the court entered an order permanently enjoining Bernstein, by consent, 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(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20 and 13a-13 thereunder. Bernstein was also ordered to pay a $125,000 civil money penalty.

4. The Commission's complaint alleged, among other things, that Bernstein, with others, analyzed the Company's reserves for expected loan losses, which showed that a substantial increase was required to account for AHM's increased loss rates on its portfolios. Bernstein did not provide this information to AHM's auditor. Instead, based on an instruction from AHM's chief financial officer, Bernstein provided to the auditor a misleading document that made the Company's understated loan loss reserves appear adequate. Bernstein also took affirmative steps to conceal a significant aged receivable balance on AHM's books for the periods ending December 31, 2006 and March 31, 2007 by directing a subordinate to make a series of

accounting entries designed to bury the balance in a liability account in order to mislead the Company's auditor with respect to the existence of these aged receivables. Bernstein circumvented AHM's internal controls and falsified the Company's books and records by, among other things, creating false accounting entries in connection with the aged receivables and entries which reflected the understated loan loss reserves.

IV.

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

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

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

B. After three years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Respondent, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the Respondent's or the firm's quality control system that would indicate that the Respondent will not receive appropriate supervision;

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

(d) Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

C. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy
Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61119; File No. S7-05-09)

December 4, 2009

ORDER EXTENDING AND MODIFYING TEMPORARY EXEMPTIONS UNDER THE SECURITIES EXCHANGE ACT OF 1934 IN CONNECTION WITH REQUEST FROM ICE TRUST U.S. LLC RELATED TO CENTRAL CLEARING OF CREDIT DEFAULT SWAPS, AND REQUEST FOR COMMENTS

I. Introduction

Over the past year, the Securities and Exchange Commission ("Commission") has taken multiple actions to protect investors and ensure the integrity of the nation's securities markets, including actions[1] designed to address concerns related to the market in credit default swaps ("CDS").[2] The over-the-counter ("OTC") market for CDS has been a source of

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1 See generally Securities Exchange Act Release No. 60372 (Jul. 23, 2009), 74 FR 37748 (Jul. 29, 2009) (temporary exemptions in connection with CDS clearing by ICE Clear Europe Limited), Securities Exchange Act Release No. 60373 (Jul. 23, 2009), 74 FR 37740 (Jul. 29, 2009) (temporary exemptions in connection with CDS clearing by Eurex Clearing AG), Securities Exchange Act Release No. 59578 (Mar. 13, 2009), 74 FR 11781 (Mar. 19, 2009) (temporary exemptions in connection with CDS clearing by Chicago Mercantile Exchange Inc.), Securities Exchange Act Release No. 59527 (Mar. 6, 2009), 74 FR 10791 (Mar. 12, 2009) (temporary exemptions in connection with CDS clearing by ICE US Trust LLC (now "ICE Trust U.S. LLC")) (hereinafter, the "March ICE Trust Order"), Securities Exchange Act Release No. 59164 (Dec. 24, 2008), 74 FR 139 (Jan. 2, 2009) (temporary exemptions in connection with CDS clearing by LIFFE A&M and LCH.Clearnet Ltd.) and other Commission actions discussed therein.

In addition, we have issued interim final temporary rules that provide exemptions under the Securities Act of 1933 and the Securities Exchange Act of 1934 for CDS to facilitate the operation of one or more central counterparties for the CDS market. See Securities Act Release No. 8999 (Jan. 14, 2009), 74 FR 3967 (Jan. 22, 2009) (initial approval); Securities Act Release No. 9063 (Sep. 14, 2009), 74 FR 47719 (Sep. 17, 2009) (extension until Nov. 30, 2010).

Further, the Commission has provided temporary exemptions in connection with Sections 5 and 6 of the Securities Exchange Act of 1934 for transactions in CDS. See Securities Exchange Act Release No. 59165 (Dec. 24, 2008), 74 FR 133 (Jan. 2, 2009) (initial exemption); Securities Exchange Act Release No. 60718 (Sep. 25, 2009), 74 FR 50862 (Oct. 1, 2009) (extension until Mar. 24, 2010).

2 A CDS is a bilateral contract between two parties, known as counterparties. The value of this financial contract is based on underlying obligations of a single entity ("reference entity") or on a particular security or other debt obligation, or an index of several such entities, securities, or obligations. The obligation of a seller to make payments under a CDS contract is triggered by a default or other credit event as to such entity or entities or such security or securities. Investors may

particular concern to us and other financial regulators, and we have recognized that facilitating the establishment of central counterparties ("CCPs") for CDS can play an important role in reducing the counterparty risks inherent in the CDS market, and thus can help mitigate potential systemic impacts. We have therefore found that taking action to help foster the prompt development of CCPs, including granting temporary conditional exemptions from certain provisions of the federal securities laws, is in the public interest.[3]

The Commission's authority over the OTC market for CDS is limited. Specifically, Section 3A of the Securities Exchange Act of 1934 ("Exchange Act") limits the Commission's authority over swap agreements, as defined in Section 206A of the Gramm-Leach-Bliley Act.[4] For those CDS that are swap agreements, the exclusion from the definition of security in Section 3A of the Exchange Act, and related provisions, will continue to apply. The Commission's action today does not affect these CDS, and this Order does not apply to them. For those CDS that are not swap agreements ("non-excluded CDS"), the Commission's action today provides temporary conditional exemptions from certain requirements of the Exchange Act.

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use CDS for a variety of reasons, including to offset or insure against risk in their fixed-income portfolios, to take positions in bonds or in segments of the debt market as represented by an index, or to take positions on the volatility in credit spreads during times of economic uncertainty.

Growth in the CDS market has coincided with a significant rise in the types and number of entities participating in the CDS market. CDS were initially created to meet the demand of banking institutions looking to hedge and diversify the credit risk attendant to their lending activities. However, financial institutions such as insurance companies, pension funds, securities firms, and hedge funds have entered the CDS market.

3 See generally actions referenced in note 1, supra.

4 15 U.S.C. 78c-1. Section 3A excludes both a non-security-based and a security-based swap agreement from the definition of "security" under Section 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10). Section 206A of the Gramm-Leach-Bliley Act defines a "swap agreement" as "any agreement, contract, or transaction between eligible contract participants (as defined in section 1a(12) of the Commodity Exchange Act . . .) . . . the material terms of which (other than price and quantity) are subject to individual negotiation." 15 U.S.C. 78c note.

The Commission believes that using well-regulated CCPs to clear transactions in CDS provides a number of benefits, by helping to promote efficiency and reduce risk in the CDS market and among its participants, contributing generally to the goal of market stability, and by requiring maintenance of records of CDS transactions that would aid the Commission's efforts to prevent and detect fraud and other abusive market practices.[5]

Earlier this year, the Commission granted temporary conditional exemptions to ICE Trust U.S. LLC ("ICE Trust") and certain related parties to permit ICE Trust to clear and settle CDS transactions.[6] Those exemptions are scheduled to expire on December 7, 2009. ICE Trust has requested that the Commission extend the exemptions, and expand them to address activities in connection with ICE Trust clearing CDS transactions of its members' customers (in addition to clearing CDS transactions of members and their affiliates, as permitted by the current exemption).[7]

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[5] See generally actions referenced in note 1, supra.

[6] For purposes of this Order, "Cleared CDS" means a credit default swap that is submitted (or offered, purchased, or sold on terms providing for submission) to ICE Trust, that is offered only to, purchased only by, and sold only to eligible contract participants (as defined in Section 1a(12) of the Commodity Exchange Act as in effect on the date of this Order (other than a person that is an eligible contract participant under paragraph (C) of that section)), and in which: (i) the reference entity, the issuer of the reference security, or the reference security is one of the following: (A) an entity reporting under the Exchange Act, providing Securities Act Rule 144A(d)(4) information, or about which financial information is otherwise publicly available; (B) a foreign private issuer whose securities are listed outside the United States and that has its principal trading market outside the United States; (C) a foreign sovereign debt security; (D) an asset-backed security, as defined in Regulation AB, issued in a registered transaction with publicly available distribution reports; or (E) an asset-backed security issued or guaranteed by the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac") or the Government National Mortgage Association ("Ginnie Mae"); or (ii) the reference index is an index in which 80 percent or more of the index's weighting is comprised of the entities or securities described in subparagraph (i). As discussed above, the Commission's action today does not affect CDS that are swap agreements under Section 206A of the Gramm-Leach-Bliley Act. See text at note 4, supra.

[7] See Letter from Kevin McClear, ICE Trust, to Elizabeth Murphy, Secretary, Commission, Dec. 4, 2009 ("December 2009 request").

Based on the facts presented and the representations made on behalf of ICE Trust,[8] and for the reasons discussed in this Order, and subject to certain conditions, the Commission is extending the exemption granted in the March ICE Trust Order, and is expanding it to accommodate customer clearing. Specifically, the Commission is extending the temporary ICE Trust conditional exemption from clearing agency registration under Section 17A of the Exchange Act solely to perform the functions of a clearing agency for certain non-excluded CDS transactions. The Commission also is extending the temporary exemption of eligible contract participants and others from certain Exchange Act requirements with respect to non-excluded CDS cleared by ICE Trust. In addition, this order conditionally exempts on a temporary basis ICE Trust clearing members from broker-dealer registration requirements and related requirements in connection with using ICE Trust to clear CDS transactions of their customers. The Commission further is extending the temporary exemption of ICE Trust and certain of its clearing members from the registration requirements of Sections 5 and 6 of the Exchange Act solely in connection with the calculation of mark-to-market prices for non-

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Market participants have committed to achieve customer access to CDS clearing by December 15, 2009. See Letter from dealers and buy-side institutions to Federal Reserve Bank of New York (Jun. 2, 2009) (http://www.newyorkfed.org/newsevents/news/markets/2009/060209letter.pdf) ("It is our goal to achieve buy-side access to CDS clearing (through either direct CCP membership or customer clearing) with customer initial margin segregation and portability of customer transactions no later than December 15, 2009.").

8 See December 2009 request. The exemptions we are granting today are based on all of the representations made in the December 2009 request on behalf of ICE Trust, which incorporate representations made on behalf of ICE Trust as part of the request that preceded our earlier relief in connection with CDS clearing by ICE Trust. We recognize, however, that there could be legal uncertainty in the event that one or more of the underlying representations were to become inaccurate. Accordingly, if any of these exemptions were to become unavailable by reason of an underlying representation no longer being materially accurate, the legal status of existing open positions in non-excluded CDS that previously had been cleared pursuant to the exemptions would remain unchanged, but no new positions could be established pursuant to the exemptions until all of the underlying representations were again accurate.

excluded CDS cleared by ICE Trust. These exemptions are temporary and will expire on March 7, 2010.

II. Discussion

A. Description of ICE Trust's Activities to Date and Proposed Customer Clearing Activities

ICE Trust's request for an extension of its current temporary exemptions and for an expansion of those exemptions to accommodate clearing of customer CDS transactions describes how ICE Trust has cleared CDS to date and how the proposed arrangements for central clearing of customer CDS transactions would operate.[9] The request also makes representations about the safeguards associated with those arrangements, as described below.[10]

1. ICE Trust CDS Clearing Activity to Date

ICE Trust has cleared the proprietary index CDS transactions of its clearing members since March 9, 2009, through acceptance and novation of those transactions.[11] As of October 30, 2009, ICE Trust had cleared approximately $2.64 trillion notional amount of CDS contracts based on indices of securities. ICE Trust intends in the near future to also clear single-name CDS contracts based on individual reference entities or securities.

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[9] See December 2009 request, supra note 7. The description in this Order of ICE Trust's proposed activities also is based on the provisions of ICE Trust's rules.

[10] ICE Trust has represented that there have been no material changes to the representations made in the letter that preceded the relief we initially granted to it, apart from the proposal to clear customer CDS transactions, and ICE Trust has incorporated the representations made in its earlier letter into the current request for relief.

[11] ICE Trust novates those cleared proprietary CDS transactions by becoming the seller of credit protection to the clearing member that is the buyer under the CDS, and the buyer of credit protection from the clearing member that is the seller under the CDS. ICE Trust collects initial and mark-to-market margin to secure each clearing member's obligations to ICE Trust under the cleared transactions, and ICE Trust has established a guaranty fund to provide additional financial protection in the case of clearing member default.

In clearing CDS transactions, ICE Trust has made use of procedures, described in the initial request for relief, whereby it has periodically required participants to execute certain CDS trades at the applicable end-of-day settlement price to enhance the reliability of end-of-day settlement prices submitted as part of the daily mark-to-market process.[12] ICE Trust represents that it wishes to continue periodically requiring clearing members to execute certain CDS trades in this manner, and has requested the extension of the applicable relief.

2. <u>Proposed Activity Clearing CDS Transactions of Members' Clients</u>

ICE Trust has proposed a "Non-Member Framework" for clearing the CDS transactions of its members' clients. Under this framework, client positions could be submitted to ICE Trust for clearing in one of two ways. First, under the "bilateral model," clients could execute a CDS transaction directly with a clearing member (acting in a principal capacity), followed by the clearing member submitting a trade to ICE Trust with terms corresponding to the client-member trade; if the latter trade is accepted by ICE Trust,[13] two positions would be created within ICE Trust – a Client Position of the clearing member that mirrors the transaction between the client and the clearing member, and an offsetting House Position of the clearing member.[14]

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[12] In particular, as part of this mark-to-market process, ICE Trust periodically requires clearing members to execute certain CDS trades at the price where the prices submitted by clearing members cross. ICE Trust requires these trades on 30 random days during any year and at the end of each quarter.

[13] ICE Trust will accept all CDS that meet the standards set forth in its rules, unless it determines not to accept the transaction for risk management reasons.

[14] "Client Positions" are cleared CDS transactions between ICE Trust and the clearing member that are offset or mirrored on a back-to-back basis by CDS transactions between the clearing member and the client. "House Positions" are all other cleared CDS transactions of a member, or affiliate, and ICE Trust.

ICE Trust would not have market exposure in connection with that transaction because it would have two offsetting positions with the clearing member.

Alternatively, under the "prime broker" or "designated clearing member" (or "DCM") model, a client could agree to a CDS transaction with an ICE Trust clearing member ("executing dealer") other than the member that clears the client's transactions. Then, pursuant to a give-up or similar agreement, the clearing member (as prime broker) and the executing dealer would enter into a trade that is submitted to ICE Trust for clearing, and the clearing member and the client would simultaneously enter into a trade.[15] The net result would be that the client's clearing member and the client would be counterparties to one transaction, the clearing member would have a Client Position with ICE Trust, and the executing dealer would have a House Position with ICE Trust.[16]

ICE Trust has no rule requiring an executing dealer to be a clearing member. ICE Trust Clearing Rule 314, moreover, requires that ICE Trust ensure that there shall be open access to its clearing system for all execution venues and trade processing platforms.[17]

ICE Trust expects that transactions under the DCM model will be submitted to ICE Trust through one or more "authorized trade processing platforms" that will facilitate the affirmation of the trade terms by the client, executing dealer and DCM, as well as the

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15 ICE Trust expects that, initially, client transactions likely will be submitted for clearing using the DCM model. These transactions will be subject to DCM Standard Terms, published by ICE Trust, that will provide procedures and timing requirements for submitting transactions to clearing. ICE Trust expects that the bilateral model will be used initially for back-loading of existing transactions into central clearing.

16 As with the bilateral model, ICE Trust would not have market exposure in connection with the cleared transaction. In this situation the clearing member's Client Position with ICE Trust would offset the executing dealer's House Position with ICE Trust.

17 ICE Trust Clearing Rule 314. Based on market feedback, ICE Trust anticipates that, initially, executing dealers will be Clearing Members. ICE Trust does not prohibit an executing dealer that is not a Clearing Member from having a trade submitted for clearance at ICE Trust through the Clearing Member. However, currently none of the "authorized trade processing platforms" permit, as an operational matter, such an arrangement. ICE Trust Clearing Rules, however, do provide for open access to its clearing system for all execution venues and trade processing platforms.

electronic submission of the affirmed trade to ICE Trust for clearing.[18] ICE Trust also expects that the platform would submit, to the relevant parties, notice of ICE Trust's acceptance or rejection of the trade. Authorized trade processing platforms may provide additional back-office or similar services to clearing members or clients. ICE Trust expects to enter into arrangements to accept transactions from multiple authorized trade processing platforms.[19]

Under the framework for clearing client transactions, ICE Trust would have no direct relationship with, or liability to, clients. To facilitate the transfer or liquidation of client-member transactions in the event of clearing member default, however, clearing members would pledge to ICE Trust the clearing members' rights under the client-member transactions and their rights to related margin, to secure the clearing members' obligations to ICE Trust under the related client positions, and the clearing member's obligations to other clients under other client-member transactions.

The cleared CDS transaction between the clearing member and its client will be documented pursuant to a negotiated International Swaps and Derivatives Association ("ISDA") master agreement between those parties, supplemented by a standard annex approved by ICE Trust. This standard annex would treat these cleared client-member CDS

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18 Under this approach, for example, when a client and executing dealer agree to the terms of a transaction (including that the transaction should be submitted to ICE Trust for clearing), the executing dealer will submit the trade terms to the authorized trade processing platform, which will forward those terms to the client for affirmation. Once the client has affirmed the trade, the platform will forward those terms to the DCM designated by the client for affirmation. Once all three parties have affirmed the transaction, it will be submitted to ICE Trust for clearing. ICE Trust will determine whether to accept or reject the submitted trade in accordance with its risk management policies and procedures.

19 ICE Trust states that it has committed to ensure that there will be open access to ICE Trust's clearing system for platforms that meet ICE Trust's qualifications and criteria to provide the necessary services.

transactions differently from other derivatives transactions between those parties: it would make the cleared CDS transactions subject to separate ICE Trust margin requirements, it would incorporate a standard definition of clearing member default (based on a determination by ICE Trust), and it would specify procedures for remedies in the case of clearing member default. As discussed below, under the standard annex the client could also agree that certain default portability rules would apply.[20]

3. Framework for Collection and Protection of Client Margin

ICE Trust states that the Non-Member Framework is intended to protect clients from default by their clearing members, particularly with regard to their initial margin. Also, the Non-Member Framework, and central clearing of CDS generally, is intended to enhance the financial stability of CDS markets as a whole.[21]

a. Margin requirements for clearing members and clients

ICE Trust rules will require clearing members to collect initial and variation margin from clients for CDS transactions cleared by ICE Trust, in an amount at least equal to the amount of margin ICE Trust would require on a gross basis for the related Client Positions. Clearing members would be able to collect additional margin from customers beyond what ICE Trust rules require.[22]

Clearing members will be permitted to calculate the initial margin collected from individual clients on a net basis, across all of the CDS transactions of that customer that are cleared through ICE Trust. Clearing members, however, would not be permitted to net across

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20 See part II.A.4.c, infra.

21 ICE Trust states that it will implement a program to monitor for its clearing members' compliance with this segregation framework.

22 As discussed below, this Order sets forth conditions intended to protect all of the margin that clearing members collect from their clients, including this type of "additional" margin.

multiple clients cleared through ICE Trust. This required "ICE Gross Margin" that a clearing member collects from a client must be pledged by the client in favor of the clearing member, and must not be subject to liens or other encumbrances in favor of third-parties.

Under ICE Trust rules, clearing members must post the ICE Gross Margin they collect from clients to ICE Trust, as custodian, promptly upon receipt, and it is expected that clearing members would transfer this margin on the business day of receipt.[23] Prior to posting, the clearing member must maintain that ICE Gross Margin in a segregated client omnibus account or in an individual segregated client account, on its own books or on the books of a custodian, pursuant to which the clearing member would receive the margin in an agency or custodial capacity.

ICE Trust will determine a net initial margin requirement for each clearing member with regard to the cleared CDS positions of all of the member's clients. Clearing members could use collateral posted by clients to satisfy this "ICE Net Margin" obligation.[24]

b. Treatment of client margin required pursuant to ICE Trust rules

Clearing members must post all the margin they collect from customers pursuant to ICE Trust requirements – both the ICE Net Margin and the remainder of the margin that

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[23] ICE Trust states, however, that this may not be feasible when the clearing member receives the client margin toward the end of the business day.

Clearing members and clients may agree that the clearing member will post with ICE Trust a different type of collateral than what the client posts with ICE Trust, and that the collateral posted with ICE Trust will become the client's property. Thus, for example, a client and clearing member may agree that cash collateral that the client posts to the clearing member may be invested in U.S. Treasury securities, and posted to ICE Trust as such.

[24] Clearing members also may initially satisfy this obligation with their proprietary assets, pending receipt of required margin from their clients.

clearing members collect from their clients pursuant to ICE Trust rules – to the Custodial Client Omnibus Margin Account[25] that would be maintained at ICE Trust or a subcustodian.

The Custodial Client Omnibus Margin Account will be held for the benefit of all clients of the relevant clearing member (or for the clearing member as agent or custodian on behalf of such clients), and will be segregated from other assets of the clearing member (including assets in its proprietary "House Account"). The Custodial Client Omnibus Margin Account will consist of a cash collateral subaccount for cash margin and a custody subaccount for securities collateral. ICE Trust will maintain title to cash in the cash collateral subaccount (ICE Trust, however, will be obligated to return the cash as required for the benefit of the relevant client or of the clearing member as the client's agency or custodian), and ICE Trust will hold assets in the custody subaccount as custodian (subject to a security interest in favor of the clearing member or ICE Trust as applicable). Assets in the Custodial Client Omnibus Margin Account may be invested in a range of investments as permitted by ICE Trust's Custodial Asset Policies,[26] and the clearing member and its client may agree how the return on those investments may be distributed between them. ICE Trust rules will require clearing members to maintain records of the identity of the clients, the margin they post, the transfer of those assets to the Custodial Client Omnibus Margin Account and the use of that margin.

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25 The "Custodial Client Omnibus Margin Account" is one or more accounts maintained by or on behalf of ICE Trust "with respect to a Participant for the purposes of holding on an omnibus basis margin of Non-Participant Parties posted to that Participant in respect of their respective Minimum ICE Trust Required Initial Margin and Participant Excess Margin requirements, as applicable." ICE Trust rules state that ICE Trust may establish a separate account or subaccount with respect to a portion of the Custodial Client Omnibus Margin Account corresponding to the Net Client Omnibus Margin Amount.

26 ICE Trust states that these generally include assets of the type allowed under CFTC Rule 1.25. However, a narrower range of assets is acceptable margin for satisfying the net margin requirement. This includes only cash in specified currencies and G-7 government debt for initial margin, and only cash for mark-to-market margin.

c. Treatment of additional margin that clearing members collect from clients beyond ICE Trust requirements

Clearing members may collect margin from clients, in connection with Cleared CDS transactions, in excess of the margin that ICE Trust rules require they collect. ICE Trust permits this "additional" margin to be posted to the Custodial Client Omnibus Margin Account, but does not require that it be posted to that account. Under the conditions of this Order's temporary exemption from certain broker-dealer related requirements of the Exchange Act, however, such "additional" margin must be posted either to the Custodial Client Omnibus Margin Account, or else to a third-party custodian that is unaffiliated with the clearing member.[27] The temporary exemption from those broker-dealer related requirements is unavailable to any clearing member that fails to segregate customer collateral in that manner.

d. Treatment of variation margin

ICE Trust states that the amount of variation margin that must be provided to a client, or by a client, will be determined daily for that client's portfolio based on ICE Trust's end-of-day settlement price determinations. ICE Trust further states that in the event that ICE Trust owes variation margin to a clearing member in respect of client positions that have moved in the client's favor, the standard annex would provide that the clearing member has a corresponding obligation to provide variation margin in favor of clients.[28]

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27 See Part II.E, infra.

28 Over the duration of this temporary exemption, the staff intends to evaluate the protections afforded to clients' mark-to-market profits associated with Cleared CDS positions, and to consider the potential benefits of requiring clearing members to segregate clients' variation margin in connection with Cleared CDS positions.

4. Default and portability rules

a. Termination amounts

In the event a client-member transaction is terminated due to clearing member default, termination amounts owed by a client on CDS transactions cleared by ICE Trust would not be netted against termination amounts owed with respect to the client's other trades with that clearing member. This is intended to facilitate portability of positions.

Moreover, in the event of member default, ICE Trust would undertake a close-out process that separately would calculate net termination with respect to the closeout of the clearing member's House Positions and its Client Positions. ICE Trust would not undertake this process, however, in the event that the defaulting clearing member's receiver (such as the Federal Deposit Insurance Corporation or similar authority) transfers the relevant positions to another non-defaulting entity in accordance with applicable law.

The rules generally would not permit netting between a clearing member's Client Positions and House Positions; however, ICE Trust would offset any amount that the clearing member owes to ICE Trust in respect of Client Positions against any amount that ICE Trust owes to the clearing member in respect of House Positions.

If a clearing member default is due to a default resulting from a client's position, ICE Trust may use the margin posted to the clearing member's Custodial Client Omnibus Margin Account up to the amount of the ICE Net Margin requirement.[29] ICE Trust will not be able to

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[29] ICE Trust cannot use a client's positions in this account if the clearing member's default was the result of its proprietary activities, rather than the result of a default resulting from a client's position.

In the event of a clearing member's default resulting from a Client Position, net losses to ICE Trust would be paid from the following sources in order: (i) any margin of the defaulting client held in the Custodial Client Omnibus Margin Account, to the extent of that client's obligations to the clearing member; (ii) amounts received from clients under their client-member transactions; (iii) the access the remainder of the assets of a non-defaulting client in the account in amounts above the net margin requirement.[30] The Commission notes that, as a result of these rules, clients of a clearing member are subject to the risk of loss resulting from the default of another client of that clearing member, up to the amount of the clearing member's net margin requirement.

b. Pre-default portability

ICE Trust rules require clearing members to agree to the transfer of client-member transactions and related positions upon client request, provided that the client obtains a new clearing member willing to accept the positions. In connection with that transfer, ICE Trust would move related margin between the Custodial Client Omnibus Margin Accounts of the two clearing members.

c. Post-default portability

If a client agrees to the application of the default rules set forth in the standard annex, it would consent that, in the event of the clearing member's default, ICE Trust may transfer client-member transactions to a new clearing member, or otherwise establish replacement transactions.[31] The client also would agree not to exercise its rights to terminate during the transfer period.[32]

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defaulting clearing member's house margin; (iv) the defaulting clearing member's contribution to the guaranty fund; (v) the defaulting clearing member's Custodial Client Omnibus Margin Account up to the amount of the net margin requirement; and (vi) other guaranty fund contributions. ICE Trust would not need to apply these assets to the extent it can close out or replace the defaulting clearing member's transactions without loss to ICE Trust.

30 ICE Trust, however, could apply all of the margin that a defaulting client has posted into the account.

31 Under the standard annex, only the client – and not the clearing member – can elect as to whether the default portability rules will apply to the cleared transaction.

If the client does not agree to the use of the default portability rules, then the customer could apply the liquidation procedures discussed below in part II.A.4.d upon the clearing member's default.

32 The transfer period will be limited to three business days or fewer.

If the clearing member is in default, ICE Trust rules would permit ICE Trust to transfer, or arrange for the transfer of, the defaulting clearing member's client positions and related transactions and margin to a new clearing member. Alternatively, ICE Trust could terminate the existing transactions and establish new positions with the new clearing member. ICE Trust may attempt to transfer some or all of the client-member transactions. Also, ICE Trust may (but would not be obligated to) take into account client prearrangements for the use of one or more "backup" clearing members to which their transactions would be transferred in the event their primary clearing member defaults.

d. Liquidation procedures

If ICE Trust is unable to transfer or terminate and replace client-member transactions during the transfer period, the client may terminate the client-member transactions as provided by the terms of the agreement.[33] ICE Trust then would determine the close-out price for the client positions and the client-member transaction.

If a client owes the clearing member with respect to the cleared CDS transactions, the client's margin in the Custodial Client Omnibus Margin Account will be applied to satisfy that obligation, and thereafter would be available to pay amounts owed to ICE Trust in connection with the related client positions and other clients in respect of their client-member transactions. Conversely, clients owed by the clearing member on a net basis will have a claim for that amount, together with their pro rata share of margin being used to satisfy the ICE Net Margin Requirement.[34]

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[33] The client alternatively may opt out of the liquidation procedures, in which case the client-member transactions also will be terminated.

[34] Clients will have available, in respect of their Net Termination Claims, an amount equal to the sum of: (i) the remaining amount of the ICE Net Margin Requirement after application by ICE Trust together with any net amounts paid by ICE Trust in respect of the termination of Client Positions, plus

Clients will be separately entitled to the return of their remaining excess margin in the Custodial Client Omnibus Margin Account, except to the extent the margin is applied to satisfy the client's obligation to the clearing member.[35] Clients will share in the assets in the Custodial Client Omnibus Margin Account in proportion of their claims, but will not be entitled to the return of specific assets in that account.

5. Other Clearing Member Requirements Related to Customer Clearing

ICE Trust states that before offering the Non-Member Framework, it will adopt a requirement that clearing members subject to the framework are regulated by: (i) a signatory to the International Organization of Securities Commissions ("IOSCO") Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, or (ii) a signatory to a bilateral arrangement with the Commission for enforcement cooperation.

B. Extended Temporary Conditional Exemption from Clearing Agency Registration Requirement

On March 6, 2009, in connection with its efforts to facilitate the establishment of one or more central counterparties ("CCP") for Cleared CDS, the Commission issued the March ICE Trust Order, conditionally exempting ICE Trust from clearing agency registration under

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(ii) any termination amounts paid by Clients that is not applied by ICE Trust, plus (iii) the amount of any client's excess margin applied to its obligations. If these proceeds are insufficient to pay all Net Termination Claims, clients will share in the proceeds pro rata, based on their respective claims.

[35] The Standard Annex provides that if the clearing member is in default and the Client owes a net termination payable, amounts the client owes to the clearing member cannot be netted with amounts the clearing member owes to the Client in respect of any non-cleared Client position. Funds that the client owes to the clearing member in respect of this net termination payable secure the clearing member's obligations in favor of ICE Trust and as such will be paid directly to ICE Trust. Conversely, where the client has a net termination claim against the clearing member, the client may net the amount owed to the client against amounts owed by the client in respect of a non-cleared position.

Section 17A of the Exchange Act on a temporary basis. Subject to the conditions in that order, ICE Trust is permitted to act as a CCP for Cleared CDS by novating trades of non-excluded CDS that are securities and generating money and settlement obligations for participants without having to register with the Commission as a clearing agency. The March ICE Trust Order expires on December 7, 2009. Pursuant to its authority under Section 36 of the Exchange Act,[36] for the reasons described herein, the Commission is extending the exemption granted in that Order until March 7, 2010.

In the March ICE Trust order, the Commission recognized the need to ensure the prompt establishment of ICE Trust as a CCP for CDS transactions. The Commission also recognized the need to ensure that important elements of Section 17A of the Exchange Act, which sets forth the framework for the regulation and operation of the U.S. clearance and settlement system for securities, apply to the non-excluded CDS market. Accordingly, the temporary exemption in the March ICE Trust Order was subject to a number of conditions designed to enable Commission staff to monitor ICE Trust's clearance and settlement of CDS transactions.[37] Moreover, the temporary exemption in that order in part was based on ICE Trust's representation that it met the standards set forth in the Committee on Payment and Settlement Systems ("CPSS") and IOSCO report entitled: Recommendation for Central Counterparties ("RCCP").[38] The RCCP establishes a framework that requires a CCP to have

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[36] 15 U.S.C. 78mm. Section 36 of the Exchange Act authorizes the Commission to conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of the Exchange Act or any rule or regulation thereunder, by rule, regulation, or order, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

[37] See Securities Exchange Act Release No. 59527 (Mar. 6, 2009), 74 FR 10791 (Mar. 12, 2009).

[38] The RCCP was drafted by a joint task force ("Task Force") composed of representative members of IOSCO and CPSS and published in November 2004. The Task Force consisted of

(i) the ability to facilitate the prompt and accurate clearance and settlement of CDS transactions and to safeguard its users' assets; and (ii) sound risk management, including the ability to appropriately determine and collect clearing fund and monitor its users' trading. This framework is generally consistent with the requirements of Section 17A of the Exchange Act.

The Commission believes that continuing to facilitate the central clearing of CDS transactions – including customer CDS transactions – through a temporary conditional exemption from Section 17A would provide important risk management and systemic benefits by avoiding an interruption in those CCP clearance and settlement services. Any interruption in CCP clearance and settlement services for CDS transactions would eliminate in the future the benefits ICE Trust provides to the non-excluded CDS market during the exemptive period. Accordingly, and consistent with our findings in the March ICE Trust Order, we find pursuant to Section 36 of the Exchange Act that it is necessary and appropriate in the public interest and is consistent with the protection of investors for the Commission to extend, until March 7, 2010, the relief provided from the clearing agency registration requirements of Section 17A by the March ICE Trust Order.

Our action today balances the aim of facilitating ICE Trust's continued service as a CCP for non-excluded CDS transactions with ensuring that important elements of Commission oversight are applied to the non-excluded CDS market. The continued use of temporary exemptions will permit the Commission to continue to develop direct experience with the non-excluded CDS market. During the extended exemptive period, the Commission

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securities regulators and central bankers from 19 countries and the European Union. The U.S. representatives on the Task Force included staff from the Commission, the Federal Reserve Board, and the Commodity Futures Trading Commission.

will continue to monitor closely the impact of the CCPs on the CDS market. In particular, the Commission will seek to assure itself that ICE Trust does not act in an anticompetitive manner or indirectly facilitate anticompetitive behavior with respect to fees charged to members, the dissemination of market data, and the access to clearing services by independent CDS exchanges or CDS trading platforms.

This temporary extension of the March ICE Trust Order also is designed to assure that – as represented in the request on behalf of ICE Trust – information will continue to be available to market participants about the terms of the CDS cleared by ICE Trust, the creditworthiness of ICE Trust or any guarantor, and the clearance and settlement process for the CDS.[39] The Commission believes continued operation of ICE Trust consistent with the conditions of this Order will facilitate the availability to market participants of information that should enable them to make better informed investment decisions and better value and evaluate their Cleared CDS and counterparty exposures relative to a market for CDS that is not centrally cleared.

This temporary extension of the March ICE Trust Order is subject to a number of conditions that are designed to enable Commission staff to continue to monitor ICE Trust's clearance and settlement of CDS transactions and help reduce risk in the CDS market. These conditions require that ICE Trust: (i) make available on its Web site its annual audited financial statements; (ii) preserve records related to the conduct of its Cleared CDS clearance and settlement services for at least five years (in an easily accessible place for the first two

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[39] The Commission believes that it is important in the CDS market, as in the market for securities generally, that parties to transactions should have access to financial information that would allow them to evaluate appropriately the risks relating to a particular investment and make more informed investment decisions. See generally Policy Statement on Financial Market Developments, The President's Working Group on Financial Markets, March 13, 2008, available at: http://www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf.

years); (iii) provide information relating to its Cleared CDS clearance and settlement services to the Commission and provide access to the Commission to conduct on-site inspections of facilities, records and personnel related to its Cleared CDS clearance and settlement services; (iv) notify the Commission about material disciplinary actions taken against any of its members utilizing its Cleared CDS clearance and settlement services, and about the involuntary termination of the membership of an entity that is utilizing ICE Trust's Cleared CDS clearance and settlement services; (v) provide the Commission with changes to rules, procedures, and any other material events affecting its Cleared CDS clearance and settlement services; (vi) provide the Commission with reports prepared by independent audit personnel that are generated in accordance with risk assessment of the areas set forth in the Commission's Automation Review Policy Statements[40] and its annual audited financial statements prepared by independent audit personnel; and (vii) report all significant systems outages to the Commission.

In addition, this temporary extension of the March ICE Trust Order is conditioned on ICE Trust, directly or indirectly, making available to the public on terms that are fair and reasonable and not unreasonably discriminatory: (i) all end-of-day settlement prices and any other prices with respect to Cleared CDS that ICE Trust may establish to calculate mark-to-market margin requirements for ICE Trust clearing members; and (ii) any other pricing or valuation information with respect to Cleared CDS as is published or distributed by ICE Trust. The Commission believes this is an appropriate condition for ICE Trust's temporary continued exemption from registration as a clearing agency.

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40 See Automated Systems of Self-Regulatory Organization, Exchange Act Release No. 27445 (November 16, 1989), File No. S7-29-89, and Automated Systems of Self-Regulatory Organization (II), Exchange Act Release No. 29185 (May 9, 1991), File No. S7-12-91.

As a CCP, ICE Trust collects and processes information about CDS transactions, prices, and positions from all of its participants. With this information, a CCP calculates and disseminates current values for open positions for the purpose of setting appropriate margin levels. The availability of such information can improve fairness, efficiency, and competitiveness of the market – all of which enhance investor protection and facilitate capital formation. Moreover, with pricing and valuation information relating to Cleared CDS, market participants would be able to derive information about underlying securities and indexes. This may improve the efficiency and effectiveness of the securities markets by allowing investors to better understand credit conditions generally.

C. Extended Temporary Conditional Exemption from Exchange Registration Requirements

When we initially provided exemptions in connection with CDS clearing by ICE Trust, we granted a temporary conditional exemption to ICE Trust from the requirements of Sections 5 and 6 of the Exchange Act, and the rules and regulations thereunder, in connection with ICE Trust's calculation of mark-to-market prices for open positions in Cleared CDS. We also temporarily exempted ICE Trust participants from the prohibitions of Section 5 to the extent that they use ICE Trust to effect or report any transaction in Cleared CDS in connection with ICE Trust's calculation of mark-to-market prices for open positions in Cleared CDS. Section 5 of the Exchange Act contains certain restrictions relating to the registration of national securities exchanges,[41] while Section 6 provides the procedures for registering as a national securities exchange.[42]

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[41] In particular, Section 5 states:

We granted these temporary exemptions to facilitate the establishment of ICE Trust's end-of-day settlement price process. ICE Trust had represented that in connection with its clearing and risk management process it would calculate an end-of-day settlement price for each Cleared CDS in which an ICE Trust participant has a cleared position, based on prices submitted by the participants. ICE Trust stated that as part of this mark-to-market process, it periodically would require participants to execute certain CDS trades at the applicable end-of-day settlement price, to help ensure that the prices that the participants submit reflect their assessment of the value of each open position in Cleared CDS, thereby reducing risk by helping ICE Trust to impose appropriate margin requirements.

As part of its current request, ICE Trust has stated that since it has commenced clearing operations for Cleared CDS, it has periodically required ICE Trust clearing members to execute certain CDS trades at the applicable end-of-day settlement price. ICE Trust further represents that it wishes to continue periodically requiring clearing members to execute certain CDS trades in this manner.

As discussed above, we have found in general that it is necessary or appropriate in the public interest, and is consistent with the protection of investors, to facilitate continued CDS clearing by ICE Trust. Consistent with that finding – and in reliance on ICE Trust's representation that the end-of-day settlement pricing process, including the periodically

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> It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange . . . to effect any transaction in a security, or to report any such transactions, unless such exchange (1) is registered as a national securities exchange under section 6 of [the Exchange Act], or (2) is exempted from such registration . . . by reason of the limited volume of transactions effected on such exchange. . . .

15 U.S.C. 78e.

[42] 15 U.S.C. 78f. Section 6 of the Exchange Act also sets forth various requirements to which a national securities exchange is subject.

required trading, is integral to its risk management – we further find that it is necessary or appropriate in the public interest, and is consistent with the protection of investors that we exercise our authority under Section 36 of the Exchange Act to extend, until March 7, 2010, ICE Trust's temporary exemption from Sections 5 and 6 of the Exchange Act in connection with its calculation of mark-to-market prices for open positions in Cleared CDS, and ICE Trust clearing members' temporary exemption from Section 5 with respect to such trading activity.[43]

The temporary exemption for ICE Trust will continue to be subject to three conditions. First, ICE Trust must report the following information with respect to its calculation of mark-to-market prices for Cleared CDS to the Commission within 30 days of the end of each quarter, and preserve such reports during the life of the enterprise and of any successor enterprise:

- The total dollar volume of transactions executed during the quarter, broken down by reference entity, security, or index; and
- The total unit volume and/or notional amount executed during the quarter, broken down by reference entity, security, or index.

Reporting of this information will assist the Commission in carrying out its responsibility to supervise and regulate the securities markets.

Second, ICE Trust must establish and maintain adequate safeguards and procedures to protect participants' confidential trading information. Such safeguards and procedures shall include: (a) limiting access to the confidential trading information of participants to those

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43 We are making a technical modification to this exemption so it refers to ICE Trust's clearing members rather than "ICE Trust Participants." The latter defined term was used in our earlier Order consistent with the scope of that Order, and the term no longer is necessary given the expansion of our exemptive relief to accommodate customer clearing by ICE Trust. See note 46, infra.

employees of ICE Trust who are operating the system or responsible for its compliance with this exemption or any other applicable rules; and (b) establishing and maintaining standards controlling employees of ICE Trust trading for their own accounts. ICE Trust must establish and maintain adequate oversight procedures to ensure that the safeguards and procedures established pursuant to this condition are followed. This condition is designed to prevent any misuse of ICE Trust clearing member trading information that may be available to ICE Trust in connection with the daily marking-to-market process of open positions in Cleared CDS. This should strengthen confidence in ICE Trust as a CCP for CDS, thus promoting participation in central clearing of CDS.

Third, ICE Trust must comply with the conditions to the temporary exemption from Section 17A of the Exchange Act in this Order, given that this exemption is granted in the context of our goal of continuing to facilitate ICE Trust's ability to act as a CCP for non-excluded CDS, and given ICE Trust's representation that the end-of-day settlement pricing process, including the periodically required trading, is integral to its risk management.

D. Modified and Extended Temporary Conditional General Exemption for ICE Trust and Certain Eligible Contract Participants

As we recognized when we initially provided temporary exemptions in connection with CDS clearing by ICE Trust, applying the full panoply of Exchange Act requirements to participants in transactions in non-excluded CDS likely would deter some participants from using CCPs to clear CDS transactions. We also recognized that it is important that the antifraud provisions of the Exchange Act apply to transactions in non-excluded CDS, particularly given that OTC transactions subject to individual negotiation that qualify as security-based swap agreements already are subject to those provisions.[44]

As a result, we concluded that it is appropriate in the public interest and consistent with the protection of investors temporarily to apply substantially the same framework to transactions by market participants in non-excluded CDS that applies to transactions in security-based swap agreements. Consistent with that conclusion, we temporarily exempted ICE Trust, and certain members and eligible contract participants from a number of Exchange Act requirements, while excluding certain enforcement-related and other provisions from the scope of the exemption.

We believe that continuing to facilitate the central clearing of CDS transactions by ICE Trust through this type of temporary exemption will provide important risk management benefits and systemic benefits. We also believe that facilitating the central clearing of customer CDS transactions, subject to the conditions in this Order, will provide an opportunity for the customers of ICE Trust clearing members to control counterparty risk.

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44 While Section 3A of the Exchange Act excludes "swap agreements" from the definition of "security," certain antifraud and insider trading provisions under the Exchange Act explicitly apply to security-based swap agreements. See (a) paragraphs (2) through (5) of Section 9(a), 15 U.S.C. 78i(a), prohibiting the manipulation of security prices; (b) Section 10(b), 15 U.S.C. 78j(b), and underlying rules prohibiting fraud, manipulation or insider trading (but not prophylactic reporting or recordkeeping requirements); (c) Section 15(c)(1), 15 U.S.C. 78o(c)(1), which prohibits brokers and dealers from using manipulative or deceptive devices; (d) Sections 16(a) and (b), 15 U.S.C. 78p(a) and (b), which address disclosure by directors, officers and principal stockholders, and short-swing trading by those persons, and rules with respect to reporting requirements under Section 16(a); (e) Section 20(d), 15 U.S.C. 78t(d), providing for antifraud liability in connection with certain derivative transactions; and (f) Section 21A(a)(1), 15 U.S.C. 78u-1(a)(1), related to the Commission's authority to impose civil penalties for insider trading violations.

"Security-based swap agreement" is defined in Section 206B of the Gramm-Leach-Bliley Act as a swap agreement in which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.

Accordingly, pursuant to Section 36 of the Exchange Act, the Commission finds that it is necessary or appropriate in the public interest and is consistent with the protection of investors to exercise its authority to grant an exemption until March 7, 2010 from certain requirements under the Exchange Act. To account for the additional relief we are granting in connection with customer CDS clearing by ICE Trust, we are modifying the parameters of the relief we previously granted.

As revised, this temporary exemption applies to ICE Trust and to any eligible contract participants[45] – including any ICE Trust clearing member[46] – other than: eligible contract participants that are self-regulatory organizations; or eligible contract participants that are registered brokers or dealers.[47]

As before, under this temporary exemption, and solely with respect to Cleared CDS, those persons generally are exempt from the provisions of the Exchange Act and the rules and regulations thereunder that do not apply to security-based swap agreements. Thus, those persons would still be subject to those Exchange Act requirements that explicitly are applicable in connection with security-based swap agreements.[48] In addition, all provisions of the Exchange Act related to the Commission's enforcement authority in connection with

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[45] This exemption in general applies to eligible contract participants, as defined in Section 1a(12) of the Commodity Exchange Act as in effect on the date of this Order, other than persons that are eligible contract participants under paragraph (C) of that section.

[46] The prior exemption specifically applied to any "ICE Trust Participant," which was defined to exclude those members that submitted customer CDS trades for clearing. In light of our expansion of the ICE Trust relief to accommodate customer clearing, we no longer are limiting the exemption in that way, and are not using the "ICE Trust Participant" definition.

[47] A separate temporary exemption addresses the Cleared CDS activities of registered broker-dealers. See Part II.F, infra. Solely for purposes of this Order, a registered broker-dealer, or a broker or dealer registered under Section 15(b) of the Exchange Act, does not refer to someone that would otherwise be required to register as a broker or dealer solely as a result of activities in Cleared CDS in compliance with this Order.

[48] See note 44, supra.

violations or potential violations of such provisions would remain applicable.[49] In this way, the temporary exemption would apply the same Exchange Act requirements in connection with non-excluded CDS as apply in connection with OTC credit default swaps.

In light of the temporary conditional exemption – discussed below – that we are granting from certain Exchange Act requirements related to broker-dealers, we are modifying this temporary exemption by excluding from its scope the broker-dealer registration requirements of Section 15(a)(1),[50] and the other requirements of the Exchange Act, including paragraphs (4) and (6) of Section 15(b),[51] and the rules and regulations thereunder that apply to a broker or dealer that is not registered with the Commission.

Consistent with our earlier exemptions, and for the same reasons, this temporary exemption also does not extend to: the exchange registration requirements of Exchange Act Sections 5 and 6;[52] the clearing agency registration requirements of Exchange Act Section

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49 Thus, for example, the Commission retains the ability to investigate potential violations and bring enforcement actions in the federal courts as well as in administrative proceedings, and to seek the full panoply of remedies available in such cases.

50 15 U.S.C. 78o(a)(1).

51 Exchange Act Sections 15(b)(4) and 15(b)(6), 15 U.S.C. 78o(b)(4) and (b)(6), grant the Commission authority to take action against broker-dealers and associated persons in certain situations.

52 These are subject to a separate temporary class exemption. <u>See</u> note 1, <u>supra</u>. A national securities exchange that effects transactions in Cleared CDS would continue to be required to comply with all requirements under the Exchange Act applicable to such transactions. A national securities exchange could form subsidiaries or affiliates that operate exchanges exempt under that order. Any subsidiary or affiliate of a registered exchange could not integrate, or otherwise link, the exempt CDS exchange with the registered exchange including the premises or property of such exchange for effecting or reporting a transaction without being considered a "facility of the exchange." <u>See</u> Section 3(a)(2), 15 U.S.C. 78c(a)(2).

This Order also includes a separate temporary exemption from Sections 5 and 6 in connection with the mark-to-market process of ICE Trust, discussed above, at note 41 and accompanying text.

17A; the requirements of Exchange Act Sections 12, 13, 14, 15(d), and 16;[53] or certain provisions related to government securities.[54]

To take advantage of this temporary exemption from Exchange Act requirements, moreover, ICE Trust clearing members must be in material compliance with ICE Trust rules. Also, to help promote compliance with the exemption – discussed below – that we are granting from certain Exchange Act requirements specifically related to broker-dealers, this more general Exchange Act exemption is conditioned on any ICE Trust clearing member that participates in the clearing of Cleared CDS transactions on behalf of other persons annually providing a certification to ICE Trust that attests to whether the clearing member is relying on the temporary exemption from broker-dealer related requirements described below.[55]

E. Conditional Temporary Exemption from Broker-Dealer Related Requirements for Certain Clearing Members of ICE Trust and Others

The March ICE Trust Order did not address clearing of customer transactions by ICE Trust, and that order thus did not provide ICE Trust clearing members that hold customer collateral in connection with cleared CDS transactions with an exemption from broker-dealer requirements under the Exchange Act. Absent an exception or exemption, persons that effect

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[53] 15 U.S.C. 78l, 78m, 78n, 78o(d), 78p. Eligible contract participants and other persons instead should refer to the interim final temporary rules issued by the Commission. See note 1, supra.

[54] This exemption specifically does not extend to the Exchange Act provisions applicable to government securities, as set forth in Section 15C, 15 U.S.C. 78o-5, and its underlying rules and regulations; nor does the exemption extend to related definitions found at paragraphs (42) through (45) of Section 3(a), 15 U.S.C. 78c(a). The Commission does not have authority under Section 36 to issue exemptions in connection with those provisions. See Exchange Act Section 36(b), 15 U.S.C. 78mm(b).

[55] This condition requiring clearing members to convey information to ICE Trust as a repository for regulators, and other conditions of this Order that require clearing members or others to convey information (e.g., an audit report related to the clearing member's compliance with exemptive conditions) to ICE Trust, does not impose upon ICE Trust any independent duty to audit or otherwise review that information. These conditions also do not impose on ICE Trust any independent fiduciary or other obligation to any customer of a clearing member.

transactions in non-excluded CDS that are securities may be required to register as broker-dealers pursuant to Section 15(a)(1) of the Exchange Act.[56] Moreover, certain other requirements of the Exchange Act could apply to such persons, as broker-dealers, regardless of whether they are registered with the Commission.

It is consistent with our investor protection mandate to require securities intermediaries that receive or hold funds and securities on behalf of others to comply with standards that safeguard the interests of their customers. For example, a registered broker-dealer is required to segregate assets held on behalf of customers from proprietary assets because segregation will assist customers in recovering assets in the event the broker-dealer fails. To the extent that funds and securities are not segregated, they could be used by an intermediary to fund its own business and could be attached to satisfy debts of the intermediary if it were to fail.[57] Moreover, the maintenance of adequate capital and liquidity

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[56] Section 15(a)(1) generally provides that, absent an exception or exemption, a broker or dealer that uses the mails or any means of interstate commerce to effect transactions in, or to induce or attempt to induce the purchase or sale of, any security must register with the Commission.

Section 3(a)(4) of the Exchange Act generally defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others," but excludes certain bank securities activities. 15 U.S.C. 78c(a)(4). Section 3(a)(5) of the Exchange Act generally defines a "dealer" as "any person engaged in the business of buying and selling securities for his own account," but includes exceptions for certain bank activities. 15 U.S.C. 78c(a)(5). Exchange Act Section 3(a)(6) defines a "bank" as a bank or savings association that is directly supervised and examined by state or federal banking authorities (with certain additional requirements for banks and savings associations that are not chartered by a federal authority or a member of the Federal Reserve System). 15 U.S.C. 78c(a)(6).

[57] In the context of the December 15 commitment for customer CDS clearing, an ISDA buy-side/sell-side committee issued a report extensively analyzing the legal issues associated with segregating the collateral that customers post with members. See Distilled Report (Jul. 13, 2009) (http://www.newyorkfed.org/markets/Distilled_Report.pdf); Full Report (Jun. 30, 2009) (http://www.newyorkfed.org/markets/Full_Report.pdf); see also Press Release, "New York Fed Welcomes CDS Central Counterparty Legal Analysis" (Jul. 13, 2009) (http://www.newyorkfed.org/newsevents/news/markets/2009/an090713.html) ("'Segregation and portability are key elements in building robust central counterparties. We requested the analysis because market participants were not making enough progress to analyze and address these buy-side issues. This is a good first step and, as we move the OTC derivatives market to central clearing, we

protects customers, CCPs and other market participants. Adequate books and records (including both transactional and position records) are necessary to facilitate day to day operations as well as to help resolve situations in which an intermediary fails and either a regulatory authority or receiver is forced to liquidate the firm. Appropriate records also are necessary to allow examiners to review for improper activities, such as insider trading or fraud.

At the same time, requiring intermediaries that receive or hold funds and securities on behalf of customers in connection with transactions in non-excluded CDS to register as broker-dealers may deter the use of CCPs in customer CDS transactions, which would cause customers to lose the counterparty risk benefits of central clearing, and would lessen the systemic risk reduction benefits associated with central clearing.

Those factors argue in favor of flexibility in applying the requirements of the Exchange Act to these intermediaries, conditioned on requiring the intermediaries to take reasonable steps to help increase the likelihood that their customers would be protected in the event the intermediary became insolvent, even if those safeguards are as not as strong as those required of registered broker-dealers. This requires us to balance the goals of promoting the central clearing of customer CDS transactions against the goal of protecting customers, and to be mindful that these conditions cannot provide legal certainty that customer collateral in fact would be protected in the event an ICE Trust clearing member were to become insolvent.

In granting the temporary exemption, we also are relying on ICE Trust's representation that before offering the Non-Member Framework, it will adopt a requirement that non-U.S. clearing members subject to the framework are regulated by: (i) a signatory to

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will work to strengthen the regulatory and legal environment for buy-side clearing,' said William C. Dudley, president of the New York Fed.").

the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, or (ii) a signatory to a bilateral arrangement with the Commission for enforcement cooperation.[58]

Accordingly, pursuant to Section 36 of the Exchange Act, the Commission finds that it is necessary or appropriate in the public interest and is consistent with the protection of investors to exercise its authority to grant a conditional exemption until March 7, 2010, with respect to certain Exchange Act requirements related to broker-dealers. This exemption is available to ICE Trust clearing members other than registered broker-dealers. This exemption also is available to any eligible contract participant, other than a registered broker-dealer, that does not receive or hold funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions for other persons.[59] Solely with respect to Cleared CDS, those persons temporarily will be exempt from the broker-dealer registration requirements of Section 15(a)(1), and the other requirements of the Exchange Act (other than

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58 Non-U.S. clearing members that do not meet these criteria would not be eligible to rely on this exemption.

59 In some circumstances, an eligible contract participant that does not hold customer funds or securities nonetheless may act as a dealer in securities transactions, or as a broker (such as an inter-dealer broker).

Solely for purposes of this requirement, an eligible contract participant would not be viewed as receiving or holding funds or securities for purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions for other persons, if the other persons involved in the transaction would not be considered "customers" of the eligible contract participant under the analysis used for determining whether certain persons would be considered "customers" of a broker-dealer under Exchange Act Rule 15c3-3(a)(1). For these purposes, and for the purpose of the definition of "Cleared CDS," the terms "purchasing" and "selling" mean the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing the rights or obligations under, a Cleared CDS, as the context may require. This is consistent with the meaning of the terms "purchase" or "sale" under the Exchange Act in the context of security-based swap agreements. See Exchange Act Section 3A(b)(4).

paragraphs (4) and (6) of Section 15(b)[60]) and the rules and regulations thereunder that apply to a broker or dealer that is not registered with the Commission.

For all ICE Trust clearing members – regardless of whether they receive or hold customer collateral in connection with Cleared CDS – this temporary exemption is conditioned on the clearing member being in material compliance with ICE Trust's rules, as well as on the clearing member being in compliance with applicable laws and regulations relating to capital, liquidity, and segregation of customers' funds and securities (and related books and records provisions) with respect to Cleared CDS.

For ICE Trust clearing members that receive or hold funds or securities of U.S. persons (or who receive or hold funds or securities of any person in the case of a U.S. clearing member) – other than for an affiliate that controls, is controlled by, or is under common control with the clearing member – in connection with Cleared CDS, this temporary exemption further is conditioned on the customer not being a natural person, and on the clearing member providing certain risk disclosures to the customer.[61]

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60 As noted above, see note 51, supra, Exchange Act Sections 15(b)(4) and 15(b)(6) grant the Commission authority to take action against broker-dealers and associated persons in certain situations. Accordingly, while this exemption from broker-dealer requirements generally extends to persons that act as broker-dealers in the market for Cleared CDS (potentially including inter-dealer brokers that do not hold funds or securities for others), such persons may be subject to actions under Sections 15(b)(4) and (b)(6) of the Exchange Act.

In addition, such persons may be subject to actions under Exchange Act Section 15(c)(1), 15 U.S.C. 78o(c)(1), which prohibits brokers and dealers from using manipulative or deceptive devices. As noted above, Section 15(c)(1) explicitly applies to security-based swap agreements. Sections 15(b)(4), 15(b)(6) and 15(c)(1), of course, would not apply to persons subject to this exemption who do not act as broker-dealers or associated persons of broker-dealers.

61 The clearing member must disclose that it is not regulated by the Commission and that U.S. broker-dealer segregation requirements and protections under the Securities Investor Protection Act will not apply, that the insolvency law of the applicable jurisdiction may affect the customer's ability to recover funds and securities or the speed of any such recovery, and (if applicable) that non-U.S. members may be subject to an insolvency regime that is materially different from that applicable to U.S. persons.

Also, those clearing members that receive or hold such customer funds or securities must transfer those funds and securities, as promptly as practicable after receipt, to either the Custodial Client Omnibus Margin Account at ICE Trust[62] or an account held by a third-party custodian, as described below.

Collateral that is held at a third-party custodian, moreover, must either be held: (1) in the name of the customer, subject to an agreement in which the customer, the clearing member and the custodian are parties, acknowledging that the assets held therein are customer assets used to collateralize obligations of the customer to the clearing member, and that the assets held in the account may not otherwise be pledged or rehypothecated by the clearing member or the custodian; or (2) in an omnibus account for which the clearing member maintains daily records as to the amount owing to each customer, and which is subject to an agreement between the clearing member and the custodian specifying: (i) that all account assets are held for the exclusive benefit of the clearing member's customers and are being kept separate from any other accounts that the clearing member maintains with the custodian; (ii) that the account assets may not be used as security for a loan to the clearing member by the custodian, and shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the custodian or any person claiming through the custodian; and (iii) that the assets may not otherwise be pledged or rehypothecated by the clearing member or the custodian.[63] Under either approach, the third-party custodian cannot be affiliated with the

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62 Cash collateral transferred to ICE Trust may be invested in "Eligible Custodial Assets," as defined in ICE Trust's "Custodial Asset Policies." See note 26 supra and accompanying text. Also, collateral transferred to ICE Trust may be held at a subcustodian.

63 We do not contemplate that either of these approaches involving the use of a third-party custodian would interfere with the ability of a clearing member and its customer to agree as to how any return or losses earned on those assets would be distributed between the clearing member and its customer.

clearing member.[64] Moreover, if the third-party custodian is a U.S. entity, it must be a bank (as that term is defined in Section 3(a)(6) of the Exchange Act), have total regulatory capital of at least $1 billion,[65] and have been approved to engage in a trust business by an appropriate regulatory agency. A custodian that is not a U.S. entity must have regulatory capital of at least $1 billion,[66] and must provide the clearing member, the customer and ICE Trust with a legal opinion providing that the account assets are subject to regulatory requirements in the custodian's home jurisdiction designed to protect, and provide for the prompt return of, custodial assets in the event of the custodian's insolvency, and that the assets held in that account reasonably could be expected to be legally separate from the clearing member's assets in the event of the clearing member's insolvency. Also, cash collateral posted with the third-party custodian may be invested in other assets, consistent with the investment policies that govern collateral held at ICE Trust.[67] Finally, a clearing member that uses a third-party custodian to hold customer collateral must notify ICE Trust of that use.

Also, the restriction in both approaches on the clearing member's and the custodian's ability to rehypothecate these customer funds and securities does not preclude that collateral from being transferred to ICE Trust as necessary to satisfy variation margin requirements in connection with the customer's CDS position.

[64] For purposes of the Order, an "affiliated person" of a clearing member mean any person who directly or indirectly controls a clearing member or any person who is directly or indirectly controlled by or under common control with a clearing member; ownership of 10 percent or more of an entity's common stock will be deemed prima facie control of that entity. This standard is analogous to the standard used to identify affiliated persons of broker-dealers under Exchange Act Rule 15c3-3(a)(13), 17 CFR 240.15c3-3(a)(13).

[65] In particular, custodians that are U.S. entities must have total capital, as calculated to meet the applicable requirements imposed by the entity's appropriate regulatory agency, of at least $1 billion. The term "appropriate regulatory agency" is defined in Section 3(a)(34) of the Exchange Act, 15 U.S.C. 78c(a)(34)).

[66] Custodians that are non-U.S. entities, particularly must have total capital, as calculated to meet the applicable requirements imposed by the foreign financial regulatory authority of at least $1 billion. The term "foreign financial regulatory authority" is defined in Section 3(a)(52) of the Exchange Act, 15 U.S.C. 78c(a)(52)).

[67] See note 26, supra.

To the extent there is any delay in the clearing member transferring such funds and securities to ICE Trust or a third-party custodian,[68] the clearing member must effectively segregate the collateral in a way that, pursuant to applicable law, could reasonably be expected to effectively protect the collateral from the clearing member's creditors. The clearing member may not permit customers to "opt out" of such segregation even if applicable regulations or laws otherwise would permit such "opt out."

To facilitate compliance with the segregation practices that are required as a condition to this temporary exemption, the clearing member also must annually provide ICE Trust with a self-assessment that it is in compliance with the requirements, along with a report by the clearing member's independent third-party auditor that attests to that assessment. The report must be dated the same date as the clearing member's annual audit report (but may be separate from it), and must be produced in accordance with the standards that the auditor follows in auditing the clearing member's financial statements.

Finally, to support these segregation practices and enhance the ability to detect and deter circumstances in which clearing members fail to segregate customer collateral consistent with the exemption, this temporary exemption is conditioned on the clearing member agreeing to provide the Commission with access to information related to Cleared CDS transactions.[69] In particular, the clearing member would provide the Commission (upon request and subject to agreements reached between the Commission or the U.S. Government and an appropriate

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68 This provision is intended to address short-term technology or operational issues. ICE Trust rules require collateral to be transferred promptly on receipt, with the expectation that margin would be transferred on the same business day.

69 This requirement for clearing members to make information available to the Commission is consistent with a requirement in Exchange Act Rule 15a-6, which exempts certain foreign broker-dealers from registering with the Commission. See Exchange Act Rule 15a-6(a)(3)(i)(B).

foreign securities authority[70]) with information or documents within the clearing member's possession, custody, or control, as well as testimony of clearing member personnel and assistance in taking the evidence of other persons, that relates to Cleared CDS transactions. If, after the clearing member has exercised its best efforts to provide this information (including requesting the appropriate governmental body and, if legally necessary, its customers), the clearing member nonetheless is prohibited from providing the information by applicable foreign law or regulations, this temporary exemption shall not longer be available to the clearing member.[71]

We recognize that requiring clearing members that receive or hold customer collateral to satisfy these conditions will not guarantee that a customer would receive the return of its collateral in the event of a clearing member's insolvency, particularly in light of the fact-specific nature of the insolvency process and the multiplicity of insolvency regimes that may apply to ICE Trust's members clearing for U.S. customers. We believe, however, that these are reasonable steps for increasing the likelihood that customers would be able to access collateral in such an insolvency event. We also recognize that these customers generally may be expected to be sophisticated market participants that should be able to weigh the risks associated with entering into arrangements with intermediaries that are not registered broker-dealers, particularly in light of the disclosure required as a condition to this temporary exemption.

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[70] The term "foreign securities authority" is defined in Section 3(a)(50) of the Exchange Act, 15 U.S.C. 78c(a)(50).

[71] Consistent with the discussion above as to the loss of an exemption due to an underlying representation no longer being accurate, see note 8, supra, if a clearing member were to lose the benefit of this exemption due to the failure to provide information to the Commission as the result of a prohibition by an applicable foreign law or regulation, the legal status of existing open positions in non-excluded CDS associated with those clearing members and its customers would remain unchanged, but the clearing member could not establish new CDS positions pursuant to the exemption.

F. Extended Temporary General Exemption for Certain Registered Broker-Dealers

When we initially provided exemptions in connection with CDS clearing by ICE Trust, we granted limited exemptions from Exchange Act requirements to registered broker-dealers in connection with their activities involving Cleared CDS. In crafting these temporary exemptions, we balanced the need to avoid creating disincentives to the prompt use of CCPs against the critical role that certain broker-dealers play in promoting market integrity and protecting customers (including broker-dealer customers that are not involved with CDS transactions).

In light of the risk management and systemic benefits in continuing to facilitate CDS clearing by ICE Trust through targeted exemptions to registered broker-dealers, the Commission finds pursuant to Section 36 of the Exchange Act that it is necessary or appropriate in the public interest and is consistent with the protection of investors to exercise its authority to extend this temporary registered broker-dealer exemption from certain Exchange Act requirements until March 7, 2010.[72]

Consistent with the temporary exemptions discussed above, and solely with respect to Cleared CDS, we are temporarily exempting registered broker-dealers from provisions of the Exchange Act and the rules and regulations thereunder that do not apply to security-based swap agreements. As discussed above, we are not excluding registered broker-dealers from Exchange Act provisions that explicitly apply in connection with security-based swap

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[72] The temporary exemptions addressed above – with regard to ICE Trust, certain clearing members and certain eligible contract participants – are not available to persons that are registered as broker-dealers with the Commission (other than those that are notice registered pursuant to Exchange Act Section 15(b)(11)). Exchange Act Section 15(b)(11) provides for notice registration of certain persons that effect transactions in security futures products. 15 U.S.C. 78o(b)(11).

agreements or from related enforcement authority provisions.[73] As above, and for similar reasons, we are not exempting registered broker-dealers from: Sections 5, 6, 12(a) and (g), 13, 14, 15(b)(4), 15(b)(6), 15(d), 16 and 17A of the Exchange Act.[74]

Further we are not exempting registered broker-dealers from the following additional provisions under the Exchange Act: (1) Section 7(c),[75] regarding the unlawful extension of credit by broker-dealers; (2) Section 15(c)(3),[76] regarding the use of unlawful or manipulative devices by broker-dealers; (3) Section 17(a),[77] regarding broker-dealer obligations to make, keep and furnish information; (4) Section 17(b),[78] regarding broker-dealer records subject to examination; (5) Regulation T,[79] a Federal Reserve Board regulation regarding extension of credit by broker-dealers; (6) Exchange Act Rule 15c3-1, regarding broker-dealer net capital; (7) Exchange Act Rule 15c3-3, regarding broker-dealer reserves and custody of securities; (8) Exchange Act Rules 17a-3 through 17a-5, regarding records to be made and preserved by broker-dealers and reports to be made by broker-dealers; and (9) Exchange Act Rule 17a-13, regarding quarterly security counts to be made by certain exchange members and broker-

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73 See notes 44 and 49, supra. As noted above, broker-dealers also would be subject to Section 15(c)(1) of the Exchange Act, which prohibits brokers and dealers from using manipulative or deceptive devices, because that provision explicitly applies in connection with security-based swap agreements. In addition, to the extent the Exchange Act and any rule or regulation thereunder imposes any other requirement on a broker-dealer with respect to security-based swap agreements (e.g., requirements under Rule 17h-1T to maintain and preserve written policies, procedures, or systems concerning the broker or dealer's trading positions and risks, such as policies relating to restrictions or limitations on trading financial instruments or products), these requirements would continue to apply to broker-dealers' activities with respect to Cleared CDS.

74 We also are not exempting those members from provisions related to government securities, as discussed above.

75 15 U.S.C. 78g(c).

76 15 U.S.C. 78o(c)(3).

77 15 U.S.C. 78q(a).

78 15 U.S.C. 78q(b).

79 12 CFR 220.1 et seq.

dealers.[80] Registered broker-dealers must comply with these provisions in connection with their activities involving non-excluded CDS because these provisions are especially important to helping protect customer funds and securities, ensure proper credit practices and safeguard against fraud and abuse.[81]

G. Solicitation of Comments

When we granted our initial exemptions relief in connection with CDS clearing by ICE Trust, we solicited comment on all aspects of the exemptions, and specifically requested comment as to the duration of the temporary exemptions, the appropriateness of the exemptive conditions, and whether ICE Trust should be required to register as a clearing agency under the Exchange Act. We received no comments in response this request.

In connection with this Order extending the exemptions granted in connection with CDS clearing by ICE Trust, and expanding that relief to accommodate central clearing of customer CDS transactions, we reiterate our request for comments on all aspects of the exemptions. We particularly request comments as to the relief we are granting in connection with customer clearing, including whether ICE Trust members that clear customer CDS transactions should be required to register as broker-dealers, whether the conditions that we have placed on the relief adequately protect customer funds and securities from the threat posed by clearing member insolvency, whether additional conditions or requirements are appropriate to promote compliance with the requirements of the exemptions, and what, if any, additional conditions would be appropriate. We also particularly request comment on

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80 Solely for purposes of this temporary exemption, in addition to the general requirements under the referenced Exchange Act sections, registered broker-dealers shall only be subject to the enumerated rules under the referenced Exchange Act sections.

81 Indeed, Congress directed the Commission to promulgate broker-dealer financial responsibility rules, including rules relating to custody, the use of customer securities, the use of customers' deposits or credit balances, and the establishment of minimum financial requirements.

whether additional conditions, such as a segregation requirement, are necessary to protect customers' mark-to-market profits associated with Cleared CDS transactions that are held at clearing members; in that regard, commenters particularly are invited to discuss whether, in practice, there are impediments to customers receiving such mark-to-market profits from their clearing members promptly after they are earned.

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-05-09 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 S7-05-09. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. We will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/other.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

III. Conclusion

IT IS HEREBY ORDERED, pursuant to Section 36(a) of the Exchange Act, that, until March 7, 2010:

(a) Exemption from Section 17A of the Exchange Act.

ICE Trust U.S. LLC ("ICE Trust") shall be exempt from Section 17A of the Exchange Act solely to perform the functions of a clearing agency for Cleared CDS (as defined in paragraph (f)(1) of this Order), subject to the following conditions:

(1) ICE Trust shall make available on its Web site its annual audited financial statements.

(2) ICE Trust shall keep and preserve at least one copy of all documents, including all correspondence, memoranda, papers, books, notices, accounts, and other such records as shall be made or received by it relating to its Cleared CDS clearance and settlement services. These records shall be kept for at least five years and for the first two years shall be held in an easily accessible place.

(3) ICE Trust shall supply information and periodic reports relating to its Cleared CDS clearance and settlement services as may be reasonably requested by the Commission, and shall provide access to the Commission to conduct on-site inspections of all facilities (including automated systems and systems environment), records, and personnel related to ICE Trust's Cleared CDS clearance and settlement services.

(4) ICE Trust shall notify the Commission, on a monthly basis, of any material disciplinary actions taken against any of its members utilizing its Cleared CDS clearance and settlement services, including the denial of services, fines, or penalties. ICE Trust shall notify the Commission promptly when ICE Trust involuntarily terminates the membership of an entity that is utilizing ICE Trust's Cleared CDS clearance and settlement services. Both notifications shall describe the facts and circumstances that led to ICE Trust's disciplinary action.

(5) ICE Trust shall notify the Commission of all changes to rules, procedures, and any other material events affecting its Cleared CDS clearance and settlement services, including its fee schedule and changes to risk management practices, the day before effectiveness or implementation of such rule changes or, in exigent circumstances, as promptly as reasonably practicable under the circumstances. All such rule changes will be posted on ICE Trust's Web site. Such notifications will not be deemed rule filings that require Commission approval.

(6) ICE Trust shall provide the Commission with reports prepared by independent audit personnel that are generated in accordance with risk assessment of the areas set forth in the Commission's Automation Review Policy Statements. ICE Trust shall provide the Commission (beginning in its first year of operation) with its annual audited financial statements prepared by independent audit personnel.

(7) ICE Trust shall report all significant systems outages to the Commission. If it appears that the outage may extend for 30 minutes or longer, ICE Trust shall report the systems outage immediately. If it appears that the outage will be resolved in

less than 30 minutes, ICE Trust shall report the systems outage within a reasonable time after the outage has been resolved.

(8) ICE Trust, directly or indirectly, shall make available to the public on terms that are fair and reasonable and not unreasonably discriminatory: (i) all end-of-day settlement prices and any other prices with respect to Cleared CDS that ICE Trust may establish to calculate mark-to-market margin requirements for ICE Trust clearing members; and (ii) any other pricing or valuation information with respect to Cleared CDS as is published or distributed by ICE Trust.

(b) Exemption from Sections 5 and 6 of the Exchange Act

(1) ICE Trust shall be exempt from the requirements of Sections 5 and 6 of the Exchange Act and the rules and regulations thereunder in connection with its calculation of mark-to-market prices for open positions in Cleared CDS, subject to the following conditions:

(i) ICE Trust shall report the following information with respect to the calculation of mark-to-market prices for Cleared CDS to the Commission within 30 days of the end of each quarter, and preserve such reports during the life of the enterprise and of any successor enterprise:

(A) The total dollar volume of transactions executed during the quarter, broken down by reference entity, security, or index; and

(B) The total unit volume and/or notional amount executed during the quarter, broken down by reference entity, security, or index;

(ii) ICE Trust shall establish and maintain adequate safeguards and procedures to protect clearing members' confidential trading information. Such safeguards and procedures shall include:

(A) limiting access to the confidential trading information of clearing members to those employees of ICE Trust who are operating the system or responsible for its compliance with this exemption or any other applicable rules; and

(B) establishing and maintaining standards controlling employees of ICE Trust trading for their own accounts. ICE Trust must establish and maintain adequate oversight procedures to ensure that the safeguards and procedures established pursuant to this condition are followed; and

(iii) ICE Trust shall satisfy the conditions of the temporary exemption from Section 17A of the Exchange Act set forth in paragraphs (a)(1) – (8) of this Order.

(2) Any ICE Trust clearing member shall be exempt from the requirements of Section 5 of the Exchange Act to the extent such ICE Trust clearing member uses any facility of ICE Trust to effect any transaction in Cleared CDS, or to report any such transaction, in connection with ICE Trust's clearance and risk management process for Cleared CDS.

(c) Exemption for ICE Trust, ICE Trust clearing members, and certain eligible contract participants.

(1) Persons eligible. The exemption in paragraph (c)(2) is available to:

(i) ICE Trust; and

(ii) Any eligible contract participant (as defined in Section 1a(12) of the Commodity Exchange Act as in effect on the date of this Order (other than a person that is an eligible contract participant under paragraph (C) of that section)), including any ICE Trust clearing member, other than:

(A) an eligible contract participant that is a self-regulatory organization, as that term is defined in Section 3(a)(26) of the Exchange Act; or

(B) a broker or dealer registered under Section 15(b) of the Exchange Act (other than paragraph (11) thereof).

(2) Scope of exemption.

(i) In general. Subject to the conditions specified in paragraph (c)(3) of this subsection, such persons generally shall, solely with respect to Cleared CDS, be exempt from the provisions of the Exchange Act and the rules and regulations thereunder that do not apply in connection with security-based swap agreements. Accordingly, under this exemption, those persons remain subject to those Exchange Act requirements that explicitly are applicable in connection with security-based swap agreements (i.e., paragraphs (2) through (5) of Section 9(a), Section 10(b), Section 15(c)(1), paragraphs (a) and (b) of Section 16, Section 20(d) and Section 21A(a)(1) and the rules thereunder that explicitly are applicable to security-based swap agreements). All provisions of the Exchange Act related to the Commission's enforcement authority in connection with violations or potential violations of such provisions also remain applicable.

(ii) Exclusions from exemption. The exemption in paragraph (c)(2)(i), however, does not extend to the following provisions under the Exchange Act:

(A) Paragraphs (42), (43), (44), and (45) of Section 3(a);

(B) Section 5;

(C) Section 6;

(D) Section 12 and the rules and regulations thereunder;

(E) Section 13 and the rules and regulations thereunder;

(F) Section 14 and the rules and regulations thereunder;

(G) The broker-dealer registration requirements of Section 15(a)(1), and the other requirements of the Exchange Act (including paragraphs (4) and (6) of Section 15(b)) and the rules and regulations thereunder that apply to a broker or dealer that is not registered with the Commission;

(H) Section 15(d) and the rules and regulations thereunder;

(I) Section 15C and the rules and regulations thereunder;

(J) Section 16 and the rules and regulations thereunder; and

(K) Section 17A (other than as provided in paragraph (a)).

(3) Conditions for ICE Trust clearing members.

(i) Any ICE Trust clearing member relying on this exemption must be in material compliance with the rules of ICE Trust.

(ii) Any ICE Trust clearing member relying on this exemption that participates in the clearing of Cleared CDS transactions on behalf of other persons must annually provide a certification to ICE Trust that attests to whether the clearing member is relying on the exemption from broker-dealer related requirements set forth in paragraph (d) of this Order.

(d) Exemption from broker-dealer related requirements for ICE Trust clearing members and certain eligible contract participants.

(1) Persons eligible. The exemption in paragraph (d)(2) is available to:

(i) Any ICE Trust clearing member (other than one that is registered as a broker or dealer under Section 15(b) of the Exchange Act (other than paragraph (11) thereof)); and

(ii) Any eligible contract participant that does not receive or hold funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions for other persons (other than one that is registered as a broker or dealer under Section 15(b) of the Exchange Act (other than paragraph (11) thereof)).

(2) Scope of exemption. The persons described in paragraph (d)(1) shall, solely with respect to Cleared CDS, be exempt from the broker-dealer registration requirements of Section 15(a)(1) and the other requirements of the Exchange Act (other than Sections 15(b)(4) and 15(b)(6)) and the rules and regulations thereunder that apply to a broker or dealer that is not registered with the Commission, subject to the conditions set forth in paragraph (d)(3) with respect to ICE Trust clearing members.

(3) Conditions for ICE Trust clearing members.

(i) General condition for ICE Trust clearing members. An ICE Trust clearing member relying on this exemption must be in material compliance with the rules of ICE Trust, and also must be in material compliance with applicable laws and regulations relating to capital, liquidity, and segregation of customers' funds and securities (and related books and records provisions) with respect to Cleared CDS.

(ii) Additional conditions for ICE Trust clearing members that receive or hold customer funds or securities. Any ICE Trust clearing member that receives or holds funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions for U.S. persons (or for any person if the clearing member is a U.S. clearing member) – other than for an affiliate that controls, is controlled by, or is under common control with the clearing member – also shall comply with the following conditions with respect to such activities:

(A) The U.S. person (or any person if the clearing member is a U.S. clearing member) for whom the clearing member receives or holds such funds or securities shall not be natural persons;

(B) The clearing member shall disclose to such U.S. person (or to any such person if the clearing member is a U.S. clearing member) that the clearing member is not regulated by the Commission and that U.S. broker-dealer segregation requirements and protections under the Securities Investor Protection Act will not apply to any funds or securities held by the clearing member, that the insolvency law of the applicable jurisdiction may affect such persons' ability to recover funds and securities, or the speed of any such recovery, in an insolvency proceeding, and, if applicable, that non-U.S. clearing members may be subject to an insolvency regime that is materially different from that applicable to U.S. persons;

(C) As promptly as practicable after receipt, the clearing member shall transfer such funds and securities (other than those promptly returned to such other person) to:

(I) the clearing member's Custodial Client Omnibus Margin Account at ICE Trust; or

(II) an account held by a third-party custodian, subject to the following requirements:

(a) the funds and securities must be held either:

(1) in the name of a customer, subject to an agreement to which the customer, the clearing member and the custodian are parties, acknowledging that the assets held therein are customer assets used to collateralize obligations of the customer to the clearing member, and that the assets held in that account may not otherwise be pledged or rehypothecated by the clearing member or the custodian; or

(2) in an omnibus account for which the clearing member maintains a daily record as to the amount held in the account that is owed to each customer, and which is subject to an agreement between the clearing member and the custodian specifying that:

(i) all assets in that account are held for the exclusive benefit of the clearing member's customers and are being kept separate from any other accounts maintained by the clearing member with the custodian;

(ii) the assets held in that account shall at no time be used directly or indirectly as security for a loan to the clearing member by the custodian and shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the custodian or any person claiming through the custodian; and

(iii) the assets held in that account may not otherwise be pledged or rehypothecated by the clearing member or the custodian;

(b) the custodian may not be an affiliated person of the clearing member (as defined at paragraph (f)(2)); and

(1) if the custodian is a U.S. entity, it must be a bank (as that term is defined in section 3(a)(6) of the Exchange Act), have total capital, as calculated to meet the applicable requirements imposed by the entity's appropriate regulatory agency (as defined in section 3(a)(34) of the Exchange Act), of at least $1 billion, and have been approved to engage in a trust business by its appropriate regulatory agency;

(2) if the custodian is not a U.S. entity, it must have total capital, as calculated to meet the applicable requirements imposed by the foreign financial regulatory authority (as defined in section 3(a)(52) of the Exchange Act) responsible for setting capital requirements for the entity, equating to at least $1 billion, and provide the clearing member, the customer and ICE Trust with a legal opinion providing that the

assets held in the account are subject to regulatory requirements in the custodian's home jurisdiction designed to protect, and provide for the prompt return of, custodial assets in the event of the insolvency of the custodian, and that the assets held in that account reasonably could be expected to be legally separate from the clearing member's assets in the event of the clearing member's insolvency;

(c) such funds may be invested in Eligible Custodial Assets as that term is defined in ICE Trust's Custodial Asset Policies; and

(d) the clearing member must provide notice to ICE Trust that it is using the third-party custodian to hold customer collateral.

(D) To the extent there is any delay in transferring such funds and securities to the third-parties identified in paragraph (C), the clearing member shall effectively segregate the collateral in a way that, pursuant to applicable law, is reasonably expected to effectively protect such funds and securities from the clearing member's creditors. The clearing member shall not permit such persons to "opt out" of such segregation even if regulations or laws otherwise would permit such "opt out."

(E) The clearing member annually must provide ICE Trust with

(I) an assessment by the clearing member that it is in compliance with all the provisions of paragraphs (d)(3)(ii)(A) through (D) in connection with such activities, and

(II) a report by the clearing member's independent third-party auditor that attests to, and reports on, the clearing member's assessment described in paragraph (d)(3)(ii)(E)(I) and that is

(a) dated as of the same date as, but which may be separate and distinct from, the clearing member's annual audit report;

(b) produced in accordance with the auditing standards followed by the independent third party auditor in its audit of the clearing member's financial statements.

(F) The clearing member shall provide the Commission (upon request or pursuant to agreements reached between the Commission or the U.S. Government and any foreign securities authority (as defined in Section 3(a)(50) of the Exchange Act)) with any information or documents within the possession, custody, or control of the clearing member, any testimony of personnel of the clearing member, and any assistance in taking the evidence of other persons, wherever located, that the Commission requests and that relates to Cleared CDS transactions, except that if, after the clearing member has exercised its best efforts to provide the information, documents, testimony, or assistance, including requesting the appropriate governmental body and, if legally necessary, its customers (with respect to customer information) to permit the clearing member to provide the information, documents, testimony, or assistance to the Commission, the clearing member is prohibited from providing this information, documents, testimony, or assistance by applicable foreign law or regulations, then this exemption shall not longer be available to the clearing member.

(e) Exemption for certain registered broker-dealers.

A broker or dealer registered under Section 15(b) of the Exchange Act (other than paragraph (11) thereof) shall be exempt from the provisions of the Exchange Act and the rules and regulations thereunder specified in paragraph (c)(2), solely with respect to Cleared CDS, except:

(1) Section 7(c);

(2) Section 15(c)(3);

(3) Section 17(a);

(4) Section 17(b);

(5) Regulation T, 12 CFR 200.1 et seq.;

(6) Rule 15c3-1;

(7) Rule 15c3-3;

(8) Rule 17a-3;

(9) Rule 17a-4;

(10) Rule 17a-5; and

(11) Rule 17a-13.

(f) Definitions.

(1) For purposes of this Order, the term "Cleared CDS" shall mean a credit default swap that is submitted (or offered, purchased, or sold on terms providing for submission) to ICE Trust, that is offered only to, purchased only by, and sold only to eligible contract participants (as defined in Section 1a(12) of the Commodity Exchange Act as in effect on the date of this Order (other than a person that is an eligible contract participant under paragraph (C) of that section)), and in which:

(i) the reference entity, the issuer of the reference security, or the reference security is one of the following:

(A) an entity reporting under the Exchange Act, providing Securities Act Rule 144A(d)(4) information, or about which financial information is otherwise publicly available;

(B) a foreign private issuer whose securities are listed outside the United States and that has its principal trading market outside the United States;

(C) a foreign sovereign debt security;

(D) an asset-backed security, as defined in Regulation AB, issued in a registered transaction with publicly available distribution reports; or

(E) an asset-backed security issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae; or

(ii) the reference index is an index in which 80 percent or more of the index's weighting is comprised of the entities or securities described in subparagraph (1).

(2) For purposes of this Order, the term "Affiliated Person of the Clearing Member" shall mean any person who directly or indirectly controls a clearing member or any person who is directly or indirectly controlled by or under common control with the clearing member. Ownership of 10 percent or more of the common stock of the relevant entity will be deemed prima facie control of that entity.

By the Securities and Exchange Commission.

Florence E. Harmon

Florence E. Harmon
Deputy Secretary

December 4, 2009

Chairman Schapiro not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES AND EXCHANGE ACT OF 1934
Rel. No. 61120 / December 7, 2009

Admin. Proc. File No. 3-13335

In the Matter of the Application of

SCOTT MATHIS
c/o Hutner Klarish LLP
1359 Broadway, Suite 2001
New York, NY 10018

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION – REVIEW OF DISCIPLINARY PROCEEDINGS

Violations of Conduct and Membership Rules

Misstatements on Form U4

Registered representative and principal of member firm of registered securities association submitted Forms U4 that failed to disclose tax liens pending against him, as well as a customer complaint and a customer-initiated civil action. *Held*, association's findings of violation and sanction imposed are *sustained*.

APPEARANCES:

Eric S. Hutner, of Hutne

Marc Menchel, *Alan La* for Financial Industry Regulatory Authority,

Appeal filed: January 21, 2009
Last brief received: June 22, 2

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I.

Scott Mathis ("Mathis"), a registered representative and general securities principal of DPEC Capital, Inc. ("DPEC Capital"), an NASD member firm, seeks review of NASD disciplinary action.[1] NASD found that Mathis willfully failed to amend his Form U4 to disclose five tax liens and that he willfully failed to disclose three then-pending tax liens on two initial Forms U4, all in violation of NASD Conduct Rule 2110 and Membership Rule IM-1000-1.[2] For those violations, NASD fined Mathis $10,000 and suspended him for three months. NASD also found that Mathis failed to amend his Form U4 in a timely fashion to disclose a customer complaint and a customer-initiated civil action, also in violation of Rules 2110 and IM-1000-1. For this misconduct, Mathis was fined $2,500 and suspended for ten business days, with the two suspensions to run concurrently.[3] Because NASD found that his failures to disclose were willful, Mathis is also subject to a statutory disqualification.[4] We base our findings on an independent review of the record.

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

2 NASD Conduct Rule 2110 requires members to observe "high standards of commercial honor and just and equitable principles of trade." NASD 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.

3 NASD also imposed costs on Mathis of $5,907.67.

4 Securities Exchange Act §§ 3(a)(39) and 15(b)(4)(A), 15 U.S.C. §§ 78c(a)(39) and 78*o*(b)(4)(A).

II.

The facts in this case are largely undisputed.[5] Mathis has worked in the securities industry in a registered capacity since 1985. In August 1995, he became associated with The Boston Group LP ("The Boston Group") as a general securities representative and, in November 1995, became registered as a general securities principal with that firm. Mathis was associated with The Boston Group until July 1998 when he became associated with National Securities Corporation ("National Securities") as a general securities representative and general securities principal. Mathis was associated with National Securities until September 2000, when he voluntarily ceased his association with the firm.

On June 8, 2000, Mathis became associated with InvestPrivate, Inc. ("InvestPrivate" or the "Firm") -- a broker-dealer he founded and controlled -- as a general securities representative and general securities principal.[6] From June 2000 to April 2001, Mathis also served as the chief executive officer and chairman of the board of directors of CelebrityStartUps.com, Inc. ("CelebrityStartUps"), a development-stage company that he founded. CelebrityStartUps filed a membership application with NASD in August 2000, but voluntarily withdrew the application in April 2001.

A. Tax Liens

Mathis received five written notices of tax liens totaling $634,436.28 from the U.S. Internal Revenue Service ("IRS") between August 1996 and September 2002.

1. The first notice of tax lien, dated August 9, 1996, informed Mathis that the IRS had entered "a lien in favor of the United States" against him in the amount of $274,526.68 for unpaid taxes for the 1993 and 1994 tax years.

2. On September 23, 1998, the IRS sent Mathis a second tax lien notice in the amount of $53,302.53 for unpaid taxes due in 1995.

3. On May 11, 1999, the IRS sent Mathis a third tax lien notice in the amount of $179,429.07 for unpaid taxes due in 1997.

4. On July 2, 2002, the IRS sent Mathis a fourth tax lien notice in the amount of $92,985.14 for unpaid taxes due in 1999.

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[5] In June 2007, Mathis and NASD reached an agreement under which they stipulated to most of the facts at issue in this case.

[6] In January 2008, the name of the Firm changed to its current name, DPEC Capital, Inc.

5. On September 9, 2002, the IRS sent Mathis a fifth tax lien notice in the amount of $34,192.86 for unpaid taxes due in 2000.

Each of these notices advised Mathis that the IRS had "made a demand for payment" of the unpaid tax liability and informed him that, as a consequence of his nonpayment, "there is a lien in favor of the United States on all property and rights to property belonging to [Mathis] for the amount of these taxes . . . ." In letters sent in 1999 and 2002 approving Mathis's request to pay his back taxes in installments, the IRS advised Mathis that, although it had established an installment plan for him, it "must protect the government's interest" and, therefore, "a notice of federal tax lien has already been filed." The IRS explained to Mathis in these letters that "[a] notice of federal tax lien is a public notice that the government has a claim against your property to satisfy a debt" and that it would "release (remove) the lien" only when Mathis had finished paying what he owed. Mathis testified that he did not read this statement when he received the letters.

Mathis was associated with The Boston Group in 1996 when he received the first IRS tax lien notice. He was associated with National Securities when he received the second and third IRS lien notices. Although he was associated with these firms when the IRS notified him of the first three liens, Mathis did not amend his Form U4 to report the liens.

On January 19, 1999, Mathis completed and signed an Annual Representative Certification ("Annual Certification") for National Securities, the firm with which he was then associated. When asked on the Annual Certification whether he had "filed for bankruptcy or had any liens or judgments entered against [him], which were not previously disclosed on Form U-4," Mathis responded "NO." Additionally, when asked "[i]f you are an independent contractor, have you paid all federal, state and local taxes due in full?" Mathis answered, "YES." At the time that Mathis completed the Annual Certification, he had two federal tax liens pending against him.

The parties stipulated that Mathis completed and signed two initial Forms U4 in which he failed to disclose the tax liens. On November 25, 1999, Mathis completed and signed a Form U4 to become associated with InvestPrivate. Mathis answered "NO" to question 23(M) on Form U4 asking whether he had "any unsatisfied judgments or liens against [him]." At the time, Mathis had received the notices from the IRS of the first three tax liens. Additionally, Mathis did not complete the required Form U4 Disclosure Reporting Page ("DRP") disclosing the lien type, the lien holder, and the lien amount for these liens.

On August 21, 2000, Mathis completed and signed a Form U4 seeking registration with CelebrityStartUps and, again, answered "NO" to question 23(M) on the Form U4 asking whether he had any unsatisfied judgments or liens against him. Again, Mathis did not complete the required Form U4 DRP disclosing the lien type, the lien holder, and the lien amount for each of the liens. The parties stipulated that Mathis did not disclose the liens on his Form U4 until July 2003, after the NASD Department of Enforcement ("Enforcement") staff brought the matter to his attention during an investigation of InvestPrivate that led to the filing of the complaint against Mathis in this matter.

B. Customer Complaint and Civil Action

The parties have stipulated that Mathis failed to amend timely his Form U4 to disclose a customer complaint and a customer-initiated civil action. The stipulation states that, on December 6, 2002, Mathis received a letter of complaint from two elderly customers of InvestPrivate in which the customers alleged that Mathis and another InvestPrivate representative had recommended unsuitable investments, misrepresented the nature of the investments, and failed to disclose certain conflicts of interest. The complaint letter asked for restitution of more than $1 million. Mathis stipulated that his Form U4 was not amended to report this customer complaint until February 20, 2003, after NASD advised him that it had not been disclosed timely.

Also, in April 2002, an InvestPrivate customer brought a civil action against Mathis, InvestPrivate, and other InvestPrivate employees alleging that these defendants committed various sales practice violations, including fraud and supervisory violations, and requesting more than $2 million in damages. Mathis stipulated that he did not amend his Form U4 to report the civil action until July 7, 2003, after NASD brought the matter to his attention. The parties stipulated that the failures to amend Mathis's Form U4 to report the customer complaint and civil action were "not willful."

C. Procedural History

Enforcement sent Mathis a letter on July 3, 2003, requesting an explanation of his failure to disclose the federal tax liens on his Form U4 and reminding Mathis of his obligation to amend his Form U4 to disclose the tax liens at issue. On July 14, 2003, Mathis disclosed the tax liens in an amended Form U4 filing. On July 23, 2003, Mathis responded to Enforcement's July 3, 2003 request for information stating that, "to the best of my recollection, I was not aware of the pendency of any federal tax liens at such times and further was not aware of any obligation to report such matters on Form U-4." Mathis further responded that "the only reasons of which I am aware for why the referenced federal tax liens were filed are that there was under-withholding of federal taxes on my income and because tax returns were filed late."

In his August 2003 on-the-record interview with NASD staff (the "OTR"), Mathis did not dispute that he had received the five notices of tax liens at issue. Instead, he maintained that it was his understanding that there was a distinction between a "notice" of tax lien and being subject to a tax lien. Mathis also testified at the OTR that, at the time he received the lien notices, it had been his understanding that a lien did not exist unless and until the IRS froze one's assets. Mathis testified that, in reaching this conclusion, he did not consult with anyone else. He also stated that "a lack of concentration" caused him to answer "YES" on the Annual Certification to the question of whether he had paid all his federal, state, and local taxes, and that he did not extensively review the notices of tax liens because he had immediately forwarded them to his accountant who was handling negotiations with the IRS on a payment plan to address his federal tax debt. Mathis paid off the liens approximately one month after disclosing them in his July 14, 2003 Form U4 filing.[7]

On February 7, 2005, Enforcement filed a complaint against Mathis and others.[8] At the subsequent hearing, Mathis testified that when he received the first tax lien notice in 1996, he sought the advice of a co-worker at The Boston Group, Kye Hellmers, a former NASD district director, about whether the tax lien notice needed to be disclosed on his Form U4. According to Mathis, Hellmers advised him that the tax lien notice was not required to be disclosed because it was not a securities-related matter.

Hellmers also testified. Hellmers explained that, when he had discussed this matter with Mathis in 1996, it was his "general impression was that if matters were not directly related to the securities industry, they need not be reported on the Form U4" and that "even some matters that were more closely related to the industry, such as being named in an arbitration as a control person, need not be reported on a Form U4." Hellmers concluded that the tax lien notice "did not arise as a consequence of actions by Mr. Mathis within the securities industry" and thus "didn't rise to the level of a reportable event." However, Hellmers also noted that he had advised Mathis that "it was only [Hellmers's] opinion," and that the issue should be referred to The Boston Group's compliance department and that Mathis should do whatever the department recommended.

Hellmers forwarded this matter to the firm's compliance department. Mathis testified that the compliance department did not get back to him with an answer and, therefore, he concluded that he did not need to disclose the lien. Hellmers testified that the compliance department also did not respond to him. Hellmers concluded that the compliance department's failure to respond indicated "pretty clear[ly] that they also didn't think it needed to be reported."

Mathis further testified that, in 1993, when he was associated with Gruntal & Company, Inc. ("Gruntal"), he had received an earlier notice of tax lien and had discussed this matter with Patty O'Brian, a compliance officer at the firm, to determine his disclosure responsibility.[9] According to Mathis, O'Brian advised him that, because he had agreed to a payment plan with the IRS to resolve the tax deficiency, "there was nothing that [Mathis] needed to do."

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7 The IRS consequently released the liens in October 2003.

8 In May 2007, the parties entered into a settlement in which some of the charges were dismissed and others were settled, leaving three counts against Mathis in dispute.

9 According to Mathis's testimony, O'Brian was the director of compliance for Gruntal's Third Avenue office in New York City.

Tim Holderbaum, whom Mathis hired to design a website for InvestPrivate, testified that he advised Mathis in December 2001 that he had attempted to establish an Internet store for an affiliate of InvestPrivate but was unsuccessful because a credit check using Mathis's social security number showed that Mathis was subject to a tax lien. In an e-mail to Mathis dated December 6, 2001, Holderman wrote that he could not obtain the necessary credit approval to establish the online store "till the tax lean [sic] issue is resolved." Holderman testified that Mathis did not express surprise at the mention of his tax lien or ask questions about it.

In a decision dated December 12, 2007, an NASD Hearing Panel found that Mathis willfully failed to disclose the tax liens on his Forms U4. The Hearing Panel concluded that Mathis reasonably relied upon Hellmers's advice and that, consequently, Mathis did not act willfully with respect to events prior to January 1999. In making this finding, the Hearing Panel found the testimony of Hellmers to be credible and concluded that Mathis's reliance on the advice was reasonable given Hellmers's senior position at The Boston Group and his lengthy service as an NASD district director.

The Hearing Panel further found, however, that Mathis became aware that "there might be an issue regarding the requirement to disclose tax liens" when he falsely represented on the National Securities Annual Certification in January 1999 that he was current in his taxes and "made a conscious effort to conceal his tax liabilities from his [new] employer." The Hearing Panel stated that Mathis's awareness of a tax lien was "underscored" in December 2001 when Holderbaum told Mathis about the tax lien issue related to his credit report and Mathis "took no action." Accordingly, the Hearing Panel found that Mathis's failure to amend his Form U4 to disclose the tax liens beginning in January 1999 was willful.

Mathis appealed the Hearing Panel decision to NASD's National Adjudicatory Council ("NAC"), which affirmed the Hearing Panel's findings of violations and sanctions. Although the NAC found no reason to disturb the Hearing Panel's credibility finding with respect to the testimony of Hellmers, it disagreed with the Hearing Panel's conclusion that Mathis reasonably relied on his advice. The NAC found that Hellmers told Mathis that Hellmers's advice not to disclose the liens was only his opinion and that Mathis should follow the decision of The Boston Group compliance office. Accordingly, the NAC found that Mathis acted willfully from the time he received notice of the first tax lien in August 1996.

III.

NASD 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. This rule applies to Form U4, which is used by NASD and other self-regulatory organizations to determine the fitness of applicants for registration as securities professionals.[10] We have repeatedly stated, "[t]he candor and forthrightness of [individuals making these filings] is critical to the effectiveness of this screening process."[11] Every person submitting Form U4 has the obligation to ensure that the information provided on the form is true and accurate.[12] Filing a misleading Form U4, in addition to violating Membership Rule IM-1000-1, violates the standard of just and equitable principles of trade to which every person associated with a NASD member is held.[13]

Mathis does not challenge NASD's findings that he failed timely to amend his Form U4 to disclose five tax liens and that he failed to disclose the then-pending tax liens on two initial Forms U4. Mathis also does not dispute that he failed to amend his Form U4 in a timely fashion with respect to the customer complaints and the civil action. In doing so, he violated Membership Rule IM-1000-1 and Conduct Rule 2110.

Mathis challenges only NASD's finding that his failure to disclose the existence of federal tax liens on his Form U4 was willful. In light of NASD's findings that Mathis's failures to disclose the tax liens were willful, Mathis was also statutorily disqualified. A person is deemed to be subject to a "statutory disqualification," under Sections 3(a)(39) and 15(b)(4)(A) of the

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10 *Timothy H. Emerson, Jr.*, Exchange Act Rel. No. 60328 (July 17, 2009), 96 SEC Docket 18882, 18885 n.8; *Jason A. Craig*, Exchange Act Rel. No. 59137 (Dec. 22, 2008), 94 SEC Docket 12694, 12698; *Douglas J. Toth*, Exchange Act 58074 (July 1, 2008), 93 SEC Docket 7380, 7387-88, *petition denied,* 319 Fed. Appx. 184 (3d Cir. 2009).

11 *Emerson*, 96 SEC Docket at 18889; *Rosario R. Ruggiero*, 52 S.E.C. 725, 728 (1996) (quoting *Thomas R. Alton*, 52 S.E.C. 380, 382 (1995)) (dismissing appeal where statutorily disqualified person had failed to amend his Form U4 within ten days of statutorily disqualifying event).

12 *Guang Lu*, Exchange Act Rel. No. 51047 (Jan. 14, 2005), 84 SEC Docket at 2639, 2648, *aff'd*, 179 Fed. Appx. 702 (D.C. Cir. 2006) (citing *Robert E. Kauffman*, 51 S.E.C. 838, 840 (1993), *aff'd*, 40 F.3d 1240 (3d Cir. 1994)).

13 *Alton*, 52 S.E.C. at 382 (citing *Kauffman*, 51 S.E.C. at 840; *Roy Ray Seaton*, 47 S.E.C. 131, 133-34 (1979)).

Securities Exchange Act of 1934[14] 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."

As the U.S. Court of Appeals for the District of Columbia stated, "willfully" under the federal securities laws means that the respondent "intentionally committ[ed] the act which constitutes the violation."[15] It does not require that the person "also be aware that he is violating one of the Rules or Acts."[16] Thus, to find that Mathis's actions were willful, we need to find that Mathis voluntarily committed the acts that constituted the violation; it is not necessary for us to determine whether Mathis was aware of the rule he violated or whether he acted with a culpable state of mind. The evidence shows that Mathis voluntarily provided false answers on his Form U4 and thus willfully violated Membership Rule 1M-1000-1 and Conduct Rule 2110.

Mathis contends that he did not believe the lien notice triggered a U4 reporting obligation because he thought the IRS had notified him of a "possible lien." He explains that "it was his (mistaken) understanding that a person was subject to a lien [only] when they are denied access to their assets, *i.e.*, an asset attachment." Mathis further contends that, having worked out a payment schedule with the IRS, it was quite reasonable for him to "think the U4 form referred to some kind of 'unsatisfied' obligation and thus [was] not applicable to Mathis."[17] However, each of the IRS notices clearly informed Mathis that, as a consequence of his tax nonpayments, "there is a lien in favor of the United States on all property and rights to property belonging to [Mathis] for the amount of these taxes . . . ." Further, in its 1999 and 2002 letters approving Mathis's request to pay his back taxes in installments, the IRS again advised Mathis that, although it had established an installment plan for him, it "must protect the government's interest" and, therefore, "a notice of federal tax lien has already been filed." The IRS explained to Mathis in these letters the concept of a tax lien and its impact on Mathis's property. In addition, Mathis had been advised by Holderbaum that a credit check using Mathis's social security number had shown that Mathis was subject to a tax lien. Under these circumstances, we find no merit in Mathis's assertion that he believed that the IRS notices related to "possible" liens, rather than actual liens.

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14 *See supra* note 4.

15 *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (citing *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 802-03 (D.C. Cir. 1965)). *See also Maria T. Giesige*, Investment Advisers Act Rel. No. 2886 (May 29, 2009), 95 SEC Docket 17154, 17161 n.10; *Brendan E. Murray*, Advisers Act Rel. No. 2809 (Nov. 21, 2008), 94 SEC Docket 11961, 11968 n.10.

16 *Wonsover,* 205 F.3d at 414.

17 At least three of the liens were extant before the payment plan was approved.

Mathis further asserts that he found the term "unsatisfied judgments or liens" on Form U4 to be "unclear and ambiguous."[18] Question 23(M) on Form U4 asked whether Mathis had "any unsatisfied judgments or liens against [him]." The question contains no limitations on the kind of liens required to be disclosed and there is nothing ambiguous about whether an IRS tax lien constitutes a "lien." In 1999, National Securities asked Mathis to disclose in its Annual Certification "*any* liens . . . entered against [him], which were not previously disclosed on Form U-4," as well as unpaid taxes (emphasis added).[19] As an associated person, Mathis has a duty to comply with all applicable NASD requirements and if he found Question 23(M) to be ambiguous, it was his duty to determine whether disclosure was required.[20] As we have stated, "[i]gnorance of the [NASD]'s rules is no excuse for their violation. Participants in the securities industry must take responsibility for compliance and cannot be excused for lack of knowledge, understanding or appreciation of these requirements."[21]

Mathis contends that he justifiably relied upon the advice of senior officials at two of his former firms, Patty O'Brian, the Gruntal compliance officer, and Kye Hellmers of The Boston Group, that no Form U4 amendment was necessary and that such reliance precludes a finding of willfulness. Mathis argues that it is "well-established that willfulness in the context of U4 filings does *not* exist if the registered representative justifiably relies upon advice that no U4 amendment was necessary received from a person of suitable experience, position and knowledge."[22]

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18 Mathis maintains that this term even confused NASD's attorneys who "repeatedly referred to 'unsatisfied liens'" in their questioning at the hearing even though, as Mathis asserted, "*there is no such thing as an 'unsatisfied lien,'*" since "[a] judgment is *satisfied*; a lien is *released*" [emphasis in original].

19 Mathis suggests that he should not be criticized for his answers on the form because he did not join National Securities voluntarily but as the result of a mass transfer of registrations from The Boston Group. He also notes that he had earlier disclosed the liens to two employees at National Securities and had entered into a payment plan with the IRS. Mathis further claims that National Securities was not concerned about his financial status because he was acquiring stock in National Securities' parent. None of these reasons justifies his incorrect answers that he neither owed tax nor was subject to liens.

20 *See Craig*, 94 SEC Docket at 12698 (holding that registered representative has a "duty to determine whether the information he was providing on Form U4 was complete and accurate").

21 *Craig*, 94 SEC Docket at 12701 (citation omitted).

22 Emphasis in original.

We find no merit in this contention. With regard to the advice that Mathis claims he received from O'Brian, we note that this advice did not relate to the tax liens at issue here and it occurred several years prior to the issuance of the first of the tax liens that are the subject of this disciplinary proceeding. Moreover, O'Brian did not testify at the hearing and we have no way to know what factors and assumptions underlay her conclusion or whether she placed any fact-specific limitations on her conclusion that may not apply to this case.

With regard to the advice Hellmers allegedly gave Mathis, Hellmers testified that he had provided Mathis with only his "general impression" and "opinion" about Mathis's obligation to report the 1996 tax lien and he specifically advised Mathis that he was forwarding the matter to The Boston Group's compliance department to determine if a tax lien was a "reportable event." Moreover, Hellmers testified that he had told Mathis that "[w]hatever decision [the compliance department] made, we would go along with." It was, therefore, not reasonable for Mathis to have relied upon Hellmer's opinion that disclosure was not required when Hellmers's ultimate advice was to "go along with" the decision of The Boston Group's compliance department.

Mathis cites to three NASD disciplinary decisions -- *Andrew C. Knight,*[23] *Stephanie Ann Dixon,*[24] and *Michael K. Kalmaer*[25] -- that he asserts support his contention that he reasonably relied upon Hellmers's advice. We find these cases to be inapposite. The NAC, in rejecting respondent's argument in *Knight* that he had reasonably relied upon the advice of the supervisor in deciding not to disclose pending criminal charges on his Form U4, noted that the supervisor "had no compliance responsibility at [the firm]" and that the respondent had "failed to inquire with anyone in the [firm's] Union compliance department" concerning the necessity of disclosing the criminal charges. Here, even though the compliance department reported to Hellmers, there is no evidence that Hellmers had any direct compliance responsibility. Moreover, Hellmers testified that, after forwarding the matter to The Boston Group's compliance department, he "did not follow up" and did not think that he "even thought about the liens in any meaningful way again" until this proceeding.

In *Dixon*, the Hearing Panel concluded that the respondent's failure to disclose on her Form U4 felony criminal charges brought against her, "partially based on her mentor's advice to answer 'no' to the question about felony charges," did not excuse the false answer. In making this finding, the Hearing Panel pointed out that "[t]he mentor, a salesperson who did not examine any of the criminal court documents . . . , was not the authoritative source" for providing guidance on how to answer the question and that she should instead "have consulted her former counsel or someone in the firm's compliance department." While the Hearing Panel determined that the respondent's failure to disclose was not willful, it based its determination on both the fact that the

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23 2004 WL 3141227 (N.A.S.D.R. Apr. 27, 2004).

24 2002 WL 31955335 (N.A.S.D.R. Nov. 6, 2002).

25 2002 WL 31862087 (N.A.S.D.R. Sept. 17, 2002).

respondent had informed her mentor of the charges and, in contrast to the instant case, that she had made similar disclosure to her firm on her DRP.

Finally, in *Kalmaer*, the respondent's failure to disclose his felony arrest on his Form U4 was found to not to have been willful, in part because he had "fully disclosed the details of his arrest to his supervisors -- each a seasoned securities professional." Here, in contrast, Hellmers was not Mathis's supervisor. Moreover, there is no evidence that Mathis advised his supervisors either at The Boston Group or subsequently about the lien notices at any of the firms with which he was associated during the relevant period. Indeed, Mathis provided false answers on his 1999 National Securities' Annual Certification, evidencing his effort to avoid disclosing the liens to his supervisors.

There is no evidence in the record showing that The Boston Company's compliance department ever considered the tax lien issue and, further, it is undisputed that the compliance department never affirmatively advised Mathis that he could answer "no" to the lien question on the Form U4. It was Mathis's duty to determine whether the information he was providing on Form U4 was complete and accurate, and it is undisputed that Mathis did not attempt to follow up with the compliance department to determine whether the liens needed to be disclosed. Further, Mathis cannot shift responsibility to comply with NASD's rules to another senior person at the firm.[26] Moreover, Hellmers' suggestion that only securities industry-related liens need be disclosed is not supported by the plain language of the Form U4, which asks for "any" liens and contains no such limitation.

Mathis also disputes the NAC's finding that the undisclosed tax lien information was material. As an initial matter, Mathis asserts that the NAC erred when it held that "essentially all of the information that is reportable on the Form U4 may be considered to be material." This holding, Mathis maintains, creates an irrebuttable presumption of materiality for all of the requested information on the Form U4 and is contrary to the prevailing legal standard for determining materiality.

The test of materiality is whether the omitted information would have "significantly altered the total mix of information made available."[27] Information about the tax liens was

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[26] *See Craig*, 94 SEC Docket at 12700 (holding that a registered representative cannot "shift his responsibility to comply with NASD rules to his firm"); *Rafael Pinchas*, 54 S.E.C. 331, 338 (1999) (holding that "a registered representative is responsible for his actions and cannot shift that responsibility to the firm or his supervisors").

[27] *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (holding that, in the context of determining materiality under the antifraud provisions of Exchange Act §10(b) and Rule 10b-5 thereunder, to fulfill the materiality requirement "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable

(continued...)

material to Mathis's employers because it would have alerted them to the outside financial pressures that Mathis was facing as he performed his job. This information was material to investors because it would have allowed them to assess whether Mathis's tax problems and large financial obligations had a bearing on their confidence in him. Finally, this information was material to regulators in assessing Mathis's fitness because it would have provided them with an early notice about his financial difficulties and information on his ability to manage his financial obligations. We conclude that, in light of the large dollar amount of the liens, the number of the liens, and the lengthy period of time during which this information was not disclosed, Mathis's omissions significantly altered the total mix of information made available to NASD, other regulators, employers, and investors.[28] We, therefore, find that the tax lien information was material.

Mathis argues that the tax liens were not material because no state regulator or customer ever "took action against Mathis based on the fact that he had liens filed against him." However, whether a regulator or customer pursued an action against Mathis after 2003 upon discovering the liens (which were paid off the following month) is not dispositive. Materiality does not depend upon proof of a different outcome had the disclosure been made, but on a "showing of a substantial likelihood that, under all of the circumstances, the omitted fact would have assumed

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[27] (...continued)
investor as having significantly altered the 'total mix' of information made available") (internal citation omitted). Mathis argues that the NAC incorrectly ruled that the tax lien omission was material because it "altered" the total mix of information, while the correct materiality standard, as enunciated by the Supreme Court in *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988), is that the omitted information "significantly alter" the total mix of information. We find this to be a distinction without a difference. Decisions by both the circuit courts and the Commission occasionally have used "altered" in place of "significantly altered" when making a materiality determination. *See, e.g., SEC v. Ginsburg*, 362 F.3d 1292, 1302 (11th Cir. 2004) (holding that a reasonable investor would have viewed certain information "as altering the total mix of information available" and, thus, material); *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 387 F.3d 468, 487 (6th Cir. 2004) (stating that materiality requires that the information, "had it been presented accurately, [would] have altered the total mix of information made available") (internal citations omitted); *Kevin D. Kunz*, 55 S.E.C. 551, 562 (2002) (holding that certain financial information was material because "[i]t altered the total mix of information for the investment decision") (internal quotations omitted). In any event, as noted, we have independently reviewed the record and base our finding of materiality on the standard enunciated in *TSC Indus., Inc.* and *Basic*, *i.e.*, that the that the omitted tax lien disclosure "significantly altered" the total mix of information available.

[28] In this regard, we note that Mathis concedes in his brief that he was unable to pay his outstanding taxes before 2003 "because he needed to help support his extended family . . . and also because much of his net worth was tied up in illiquid securities."

actual significance in the deliberations of the reasonable shareholder."[29] For the reasons discussed above, we find that the tax liens would have assumed actual significance in the deliberations of Mathis's investors, as well as employers and regulators, and, therefore, are material.

Mathis further argues that the tax liens are not material because the Commission does not require liens to be disclosed in other contexts. As an example, Mathis asserts that the Commission "does not specifically require registered investment advisers to disclose personal liens."[30] He also states that the Commission "applies a rebuttable presumption of materiality with respect to disclosures made by directors and officers pursuant to Item 401(f) of Regulation S-K and Item 401(d) of Regulation S-B." However, whether disclosure of liens is required in other contexts is not relevant to a determination of the materiality of Mathis's statement on Form U4 that he did not have any liens when, in fact, he did. We have consistently held that the candor and forthrightness of applicants in completing Form U4 is critical to the effectiveness of NASD's, and other self-regulatory organizations', ability to determine the applicants' fitness for registration as a securities professional.[31] In this context, we find that Mathis's failure to disclose the tax liens in response to a question specifically asking him to disclose such information was a material omission.

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[29] *TSC Indus., Inc.*, 426 U.S. at 449.

[30] Mathis notes, in this regard, that investment advisers are only required to disclose personal liens when other factors are present, such as reasonably likely to impair the ability of the adviser to meet contractual obligations to clients. According to Mathis, the Commission's 1987 release, *Financial and Disciplinary Information that Investment Advisers Must Disclose to Clients*, Advisers Act Rel. No. 1083 (Sept. 25, 1987), 39 SEC Docket 545, offers support for his view that "much more serious events of bankruptcy and insolvency, as opposed to a personal lien, would be rebuttably material, and even then only when certain conditions not applicable here exist [and that] the significantly less serious personal lien is not material." We do not find this persuasive as the Commission release applies to financial information that is required to be disclosed by investment advisers to their clients pursuant to Section 206 of the Advisers Act and the rules thereunder in the absence of any specific request for this information, while the information at issue here is information specifically requested by the Form U4 to be disclosed by a broker-dealer associate.

[31] *See Craig*, 94 SEC Docket at 12700 (holding that "effectiveness of [Form U4] depends on applicants' candid disclosures").

Accordingly, we find that Mathis's failure to disclose on his Form U4 his five tax liens willfully violated Membership Rule IM-1000-1 and Conduct Rule 2110. We further find that Mathis failed to amend his Form U4 in a timely fashion to disclose a customer complaint and a customer-initiated civil action, also in violation of Rules IM 1000-1 and 2110.

IV.

Pursuant to Exchange Act Section 19(e)(2), we sustain NASD sanctions unless we find, giving due regard to the public interest and the protection of investors, that the sanctions are excessive, oppressive, or impose an unnecessary or inappropriate burden on competition.[32] NASD fined Mathis $10,000 and suspended him for three months.[33] We sustain the sanction imposed by NASD because, as explained below, we believe that it is neither excessive nor oppressive in light of Mathis's violative conduct and that it will adequately serve the public interest and protect investors.

We initially observe that NASD's decision to fine and suspend Mathis is consistent with NASD Sanction Guidelines.[34] For filing a false, misleading, or inaccurate Form U4, the Guidelines recommend a fine between $2,500 and $50,000 and a suspension for five to thirty business days. In egregious cases, the Guidelines recommend consideration of a longer suspension of up to two years or a bar.[35] In evaluating the appropriate sanction to impose, the Guidelines provide three "Principal Considerations," only one of which -- the "[n]ature and significance of [the] information at issue" -- is relevant here.

We conclude, as did NASD, that Mathis's failure to disclose the five tax liens was egregious. The omitted tax lien information was significant. The omissions involved tax liens for a large amount -- $634,434. They occurred over a long period of time -- approximately six

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32 15 U.S.C. § 78s(e)(2). Mathis does not claim, nor does the record show, that NASD's action imposed an unnecessary or inappropriate burden on competition.

33 NASD also fined Mathis $2,500 and suspended him for ten business days, with the two suspensions to run concurrently, for his non-willful failure to amend his Form U4 in a timely fashion to disclose a customer complaint and a customer-initiated civil action. As with the findings underlying this second sanction, Mathis is not contesting this fine and suspension. This sanction is at the minimum end of that recommended under the Sanction Guidelines and, we find, is appropriate under the circumstances.

34 NASD promulgated the Sanction Guidelines in an effort to achieve greater consistency, uniformity, and fairness in the sanctions that are imposed for violations. Although the Sanction Guidelines do not bind the Commission, they serve as a benchmark in reviewing sanctions under Exchange Act Section 19(e)(2). *Craig*, 94 SEC Docket at 12701 n.27.

35 NASD Sanction Guidelines at 77-78 (Mar. 2006).

years. This information was important to investors, employers, and regulators for the same reasons we have found it to be material.[36]

In mitigation, Mathis notes that NASD withdrew the fraud allegations against him. However, we do not find this to be mitigating. The NAC imposed sanctions on Mathis for his inaccurate disclosures, not because of the withdrawn fraud allegations.

Mathis charges that the issuance of an NASD press release in this matter caused "enormous" harm to his career and reputation. Following the issuance of the original complaint against Mathis, NASD issued a press release entitled "NASD Charges InvestPrivate, Inc. and its Chairman [Scott Mathis] with Fraudulently Raising Millions." The press release also disclosed the allegations pertaining to Mathis's tax liens. Mathis asserts that, "[t]hereafter, the press release was maliciously emailed to every InvestPrivate customer by a disgruntled former InvestPrivate employee."

As noted, NASD subsequently withdrew all allegations of fraudulent misconduct. At the NASD hearing, Mathis asserted that he suffered harm as a result of the press release remaining on NASD's website without any indication that the fraud charges had been withdrawn. In response to Mathis's request that the situation be rectified, the Hearing Panel noted that, while it did not have "the authority to direct [NASD] staff to remove the press release or append it with clarifying information," it nevertheless, "encourage[d] [NASD] to consider taking action so that people reading the press release on [NASD's] website do not have the mistaken impression that [NASD] continues to allege that Mathis engaged in fraudulent conduct." After issuance of the Hearing Panel's decision, the press release on NASD's website was modified to include the following notice: "NASD withdrew the fraud charges against InvestPrivate, Inc., Mathis, [and others]."[37] The NAC dismissed Mathis's contention that he should not have been sanctioned because of the harm he sustained as a result of the press release. The NAC noted that the statements in the press release were accurate and concluded that, in any event, publication of the information in the press release was not a mitigating factor for purposes of sanctions. We concur that the press release, which was accurate when issued, and is now accurate as updated, is not a mitigating factor for purposes of determining Mathis's sanction.

Mathis contends that the fact that NASD continued with the case after the fraud charges were withdrawn suggests NASD had an agenda or bias against him. To the extent that Mathis is alleging that he has been subject to unlawful selective prosecution in NASD's initiation and pursuit of this action against him, Mathis must prove that he was singled out for enforcement action while others similarly situated were not and that his selection as a target for enforcement

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[36] *See supra* nn.27 & 29 and accompanying text.

[37] The press release on NASD's website also provides a hyperlink to the NASD/InvestPrivate/Mathis settlement agreement. *See* http://www.finra.org/Newsroom/NewsReleases/2004/P002821.

was based on an unjustifiable consideration such as his race, religion, national origin, or the exercise of constitutionally protected rights.[38] Mathis has made no showing on the record before us that he has been subject to such improper prosecutorial decisions.

We find that the fine and suspension imposed in this case are remedial and not punitive. The information Mathis failed to disclose was material in determining whether Mathis could fulfill the high standards of conduct demanded of associated persons. By not disclosing the information, Mathis demonstrated his inability to fulfill this high standard. Mathis currently is associated with a registered broker-dealer and will continue to be required to comply with the disclosure requirements of Form U4. The sanction will encourage Mathis to make complete and

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[38] *United States v. Huff*, 959 F.2d 731, 735 (8th Cir. 1992) (setting forth elements of selective prosecution claim). *See also Fog Cutter Capital Group Inc. v. SEC*, 474 F.3d 822, 826 (D.C. Cir. 2007) (holding that in order for respondent to make a claim of selective prosecution against NASD, he must establish that he was part of a protected class under the Equal Protection Clause, "that prosecutors acted with bad intent, [and] that similarly situated individuals outside the protected category were not prosecuted" (quoting *United States v. Armstrong*, 517 U.S. 456, 465 (1996))); *Scott Epstein*, Exchange Act Rel. No. 59328 (Jan. 30, 2009), 95 SEC Docket 13833, 13856 n.44 (same); *CMG Institutional Trading, LLC*, Exchange Act Rel. No. 59325 (Jan. 30, 2009), 95 SEC Docket 13802, 13813 n.34 (same); *Robert Radano*, Advisers Act Rel. No. 2750 (June 30, 2008), 93 SEC Docket 7495, 7510 n.74 (same).

accurate disclosures in the future and will impress upon others the importance of the accuracy of the information in Form U4.[39] Accordingly, we sustain this sanction because it is neither excessive nor oppressive, is remedial, and will protect investors and the public interest.[40]

An appropriate order will issue.[41]

By the Commission (Commissioner WALTER, AGUILAR , PAREDES and CASEY); Chairman SCHAPIRO not participating.

Elizabeth M. Murphy
Secretary

Florence E Harmon
By: Florence E. Harmon
Deputy Secretary

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[39] *Paz Sec., Inc. v. SEC*, 494 F.3d 1059, 1066 (D.C. Cir. 2007) ("[A]lthough general deterrence is not, by itself, sufficient justification for expulsion or suspension[,] . . . it may be considered as part of the overall remedial inquiry." (quoting *McCarthy v. SEC*, 406 F.3d 179, 189 (2d Cir. 2005))), *petition denied*, 566 F.3d 1172 (D.C. Cir. 2009).

[40] Mathis notes that NASD's finding that he acted willfully results in his being statutorily disqualified and that this constitutes a disciplinary sanction. He argues that the effect on his career of a statutory disqualification is disproportionate to his offense. We disagree. NASD's finding that Mathis had acted willfully is justified given the number and amount of the liens, the lengthy period of time during which he failed to disclose this information, and the many opportunities he had over this period to correct his Form U4.

[41] 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. 61120 / Dember 7, 2009

Admin. Proc. File No. 3-13335

In the Matter of the Application of

SCOTT MATHIS
c/o Hutner Klarish LLP
1359 Broadway, Suite 2001
New York, NY 10018

For Review of Disciplinary Action Taken by

FINRA

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, and costs imposed, by NASD against Scott Mathis be, and they hereby are, sustained.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

Commissioner Walter
Commissioner Aguilar and
Commissioner Paredes
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61123A / December 7, 2009

INVESTMENT ADVISERS ACT OF 1940
Release No. 2958A / December 7, 2009

INVESTMENT COMPANY ACT OF 1940
Release No. 29067A / December 7, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13705

In the Matter of **SIMPSON CAPITAL MANAGEMENT, INC., ROBERT A. SIMPSON, AND JOHN C. DOWLING,** **Respondents.**	**CORRECTED ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e) AND 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(e) and 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 Simpson Capital Management, Inc. ("Simpson Capital"), Robert A. Simpson ("Simpson"), and John C. Dowling ("Dowling") (collectively "Respondents").

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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 Pursuant to Section 21C of the Securities Exchange Act of 1934, Sections 203(e) and 203(f) of the Investment Advisers Act of 1940 and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission makes the following findings:[1]

Summary

1. Between May 2000 and September 2003, Simpson, the President and founder of Simpson Capital, a hedge fund manager, conducted a fraudulent scheme involving unlawful "late trading" in shares of mutual funds. Dowling, Simpson Capital's head trader, began participating in the scheme in November 2000. Late trading refers to placing orders to buy, redeem, or exchange mutual fund shares after the 4:00 p.m. Eastern Time ("ET") market close while still receiving the current day's mutual fund price, or net asset value ("NAV"). Respondents' late trading was part of a profitable investment strategy dependent upon the execution of mutual fund trades based on post-4:00 p.m. market information not reflected in the price they paid for the shares. Simpson profited through his investment in the managed funds, and Simpson Capital, which Simpson owns, received management and performance fees.

Respondents

2. **Simpson Capital Management, Inc.**, founded by Simpson in 1998, is the investment adviser to two hedge funds: Simpson Partners, L.P. ("Simpson Partners") and Simpson Offshore, Ltd. ("Simpson Offshore") (collectively, the "Simpson Funds"). These funds operated under a master-feeder structure, in which Simpson Partners and Simpson Offshore invested nearly all of their assets in Simpson Master Investments, Ltd. The hedge fund clients paid Simpson Capital annual management and performance fees. From January 2000 to December 2003, the

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

assets under management ranged from $128.7 to $242.6 million. Simpson Capital has never been registered with the Commission.

3. **Robert A. Simpson**, age 48, resides in New York, New York. He is the founder, President, and Chief Investment Officer of Simpson Capital. At all relevant times, Simpson managed and directed the operations of the firm and was primarily responsible for all investment and trading decisions.

4. **John C. Dowling**, age 43, resides in New York, New York. From November 2000 to the present, Dowling has been employed with Simpson Capital as its head trader. At all relevant times, Dowling was responsible for research and daily trading execution.

Background-Late Trading

5. The price of a mutual fund's shares is based on the value of the securities (and other assets) held by the mutual fund, and each fund is required by the Commission's regulations to calculate the value of the fund's holdings, or NAV, each trading day.

6. Rule 22c-1(a), [17 C.F.R. § 270.22c-1], adopted pursuant to Section 22(c) of the Investment Company Act of 1940, [15 U.S.C. § 88a-22(c)], requires any registered investment company issuing redeemable securities, its principal underwriter, any dealers in its shares, and any person designated in the fund's prospectus as authorized to consummate transactions in securities issued by the fund to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to buy or redeem. The mutual funds in which the Respondents traded were registered investment companies subject to Rule 22c-1(a).

7. In accordance with the terms of their prospectuses, mutual funds, including those in which Respondents invested, generally determine the NAV of mutual fund shares as of the close of the major United States securities exchanges and markets (4:00 p.m. ET). Accordingly, orders received by the entities identified in Rule 22c-1 before 4:00 p.m. must be executed at the price determined as of 4:00 p.m. that day. Orders received by these entities after 4:00 p.m. must be executed at the price determined as of 4:00 p.m. the next trading day.

8. "Late trading" refers to the practice of placing orders to buy or redeem mutual fund shares after the time as of which a mutual fund has calculated its NAV (usually as of the close of trading at 4:00 p.m. ET), but receiving the price based on the prior NAV already determined as of 4:00 p.m. Late trading enables the trader to profit from market events that occur after 4:00 p.m. and are not reflected in that day's price. In particular, the late trader obtains an advantage -- at the expense of the other shareholders of the mutual fund -- when he learns of market moving information and is able to purchase (or redeem) mutual fund shares at prices set *before* the market moving information was released. Late trading harms innocent shareholders in mutual funds by diluting the value of their shares.

9. Simpson and Dowling late traded through at least five broker-dealers, including Kaplan & Co. Securities, Inc., Wall Street Access, Pritchard Capital Partners, LLC and two other broker-dealers (collectively, the "Introducing Brokers").

10. The Introducing Brokers cleared their trades through a number of different broker-dealers, including Bear Stearns Securities Corp., Banc of America Securities LLC, JB Oxford & Co. and another broker-dealer (collectively, the "Clearing Brokers").

11. The Introducing Brokers had direct access to the Clearing Brokers' mutual fund trading platform known as the Mutual Fund Routing System ("MFRS"). In accordance with Rule 22c-1, various dealer agreements, and the terms of mutual fund prospectuses, in general, the Introducing Brokers were required to receive orders from clients such as Respondents to purchase, redeem, or exchange shares of a fund no later than 4:00 p.m. ET to be executed at that day's NAV.

The Late Trading Scheme

12. During the relevant time period, Simpson and Dowling, through Simpson Capital, placed more than 10,700 late trades in approximately 375 mutual funds. Both knew, or were reckless in not knowing, that late trading was improper, but nonetheless sought out broker-dealers, including the Introducing Brokers, who they knew would allow them to place trades after 4:00 p.m. and would ensure the trades received that day's NAV.

13. Simpson was primarily responsible for all investment decisions at Simpson Capital and was assisted by Dowling, who executed trading instructions on behalf of Simpson Capital and, together with Simpson, orchestrated the late trading scheme. The Respondents' late trading enabled the Simpson Funds to profit from market events, futures markets information, and other fluctuations that occurred after the market closed and, therefore, were not reflected in that day's NAV. Simpson and Dowling monitored the futures markets and used news and other information disseminated after the market closed to make their trading decisions.

14. On the morning of each trading day, the Introducing Brokers would e-mail or fax to Simpson Capital a daily position sheet containing Simpson Capital's available cash balance and mutual fund holdings, and a blank scenario sheet for Simpson Capital to list its proposed trades for that day. Generally, by 3:00 p.m. each day, Simpson or Dowling filled in proposed trades for the day on the scenario sheet and then e-mailed or faxed the scenario sheet to the Introducing Broker's trading desk.

15. However, the proposed trades listed on the scenario sheets were only tentative trading instructions, and the Introducing Brokers were not authorized to execute them until Simpson or Dowling subsequently confirmed trades via telephone after 4:00 p.m.

16. After 4:00 p.m., and generally as late as possible, Simpson or Dowling telephoned or otherwise contacted the Introducing Brokers with instructions to execute, change, and/or cancel some or all of the proposed trades. Respondents did this with the understanding that all of the confirmed trades were to be executed at that day's NAV.

17. Once the traders at the Introducing Brokers received Simpson and Dowling's post-4:00 p.m. communication confirming Simpson Capital's proposed trades, the traders entered the trades directly into the Clearing Firms' MFRS platforms before the system cut off. In accordance with Simpson and Dowling's instructions, the traders at the Introducing Brokers ensured that

Simpson Capital's trades received that day's NAV even though the trades were placed after 4:00 p.m. and thus should have received the next day's NAV.

18. Simpson Capital earned management and performance fees based on the value of the Simpson Funds, which was improperly inflated by their late trading. Simpson, in turn, earned individual profits from his own investment in the Simpson Funds.

19. As a result of the conduct described above, Respondents willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities.

IV.

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

Accordingly, pursuant to Section 21C of the Exchange Act, Sections 203(e) and 203(f) of the Advisers Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Simpson Capital is hereby censured.

B. Respondents Simpson Capital, Simpson, and Dowling cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

C. Respondents Simpson and Dowling be, and hereby are, suspended from association with any investment adviser for a period of 12 months, effective on the second Monday following the entry of this Order.

D. Respondents Simpson and Dowling are 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 for a period of 12 months, effective on the second Monday following the entry of this Order.

E. Respondents Simpson Capital and Simpson shall be jointly and severally liable for disgorgement of $6,100,000 and a civil money penalty of $550,000. This sum shall be paid within 10 days of the entry of this Order to the Securities and Exchange Commission, and forwarded to the United States Treasury. If timely payment is not made, interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies the payor 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 A. Thompson, Senior Trial Counsel, Securities and Exchange Commission, 701 Market Street, Suite 2000, Philadelphia, PA 19106.

F. Respondent Dowling shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $150,000 to the Securities and Exchange Commission, which shall be forwarded to the United States Treasury. If timely payment is not made, interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies the payor 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 A. Thompson, Senior Trial Counsel, Securities and Exchange Commission, 701 Market Street, Suite 2000, Philadelphia, PA 19106.

G. All amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that they shall not, after offset or reduction in any Related Investor Action based on Respondents' payment of disgorgement in this action, argue that they are entitled to, nor shall they further benefit by offset or reduction of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61132 / December 9, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13706

In the Matter of **ROBERT J. BRADBURY and DOLPHIN AND BRADBURY, INCORPORATED,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) AND SECTION 15B(c) 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) and Section 15B(c) of the Securities Exchange Act of 1934 ("Exchange Act") against Robert J. Bradbury ("Bradbury") and pursuant to Section 15(b) of the Exchange Act against Dolphin and Bradbury, Incorporated ("D&B").[1]

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 Sections III.3 and III.4 below, which are admitted, Respondents consent to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) and Section 15B(c) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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[1] Bradbury and D&B are hereinafter referred to collectively as "Respondents".

III.

On the basis of this Order and Respondents' Offers, the Commission finds that:

1. D&B is a broker-dealer located in Philadelphia, Pennsylvania that specialized in the underwriting of municipal securities. D&B has been registered with the Commission since 1986. During the relevant time period, the firm had approximately twelve employees. D&B both underwrote the various Whitetail Notes and sold them to the school districts.

2. Bradbury, at all relevant times, was chairman, chief operating officer and 38% owner of D&B. Bradbury has at least 37 years of experience in the underwriting of municipal bonds and related broker-dealer activities, and he has been licensed with the National Association of Securities Dealers, Inc. (the "NASD," now FINRA) since 1969. Bradbury has also held a municipal securities principal license (also known as a Series 53 license) issued by the NASD since 1980. Bradbury, who is 62 years old, resides in Chester County, Pennsylvania.

3. On November 30, 2009, a final judgment was entered by consent against D&B, permanently enjoining it from future violations of Sections 17(a) of the Securities Act of 1933 ("Securities Act"), Sections 10(b), 15(c), 15B(c)(1), and 17(a) of the Exchange Act and Rules 10b-5, 15c2-12, 17a-3, and 17a-4 thereunder, as well as Rule G-17 of the Municipal Securities Rulemaking Board ("MSRB"), in the civil action entitled Securities and Exchange Commission v. Robert J. Bradbury, et al., Civil Action Number 2:06-cv-3435, in the United States District Court for the Eastern District of Pennsylvania. In addition, D&B was ordered to pay, on a joint and several basis with Bradbury and Margaret B. Bradbury, disgorgement in the amount of $3,405,000, plus prejudgment interest thereon in the amount of $1,731,628.79, provided that the total of such disgorgement and prejudgment interest (*i.e.*, $5,136,628.79) shall be deemed satisfied, at the time the Final Judgment is entered, by the settlement agreement by and between Bradbury and Margaret B. Bradbury, and Boyertown Area School District, North Penn School District, Perkiomen Valley School District, and Red Lion Area School District in the following Pennsylvania state court actions: *Perkiomen Valley School District and Boyertown Area School District v. Dolphin & Bradbury, Inc. et al.,* Docket No. 04-33358 (Ct. Com. Pl., Montgomery Co.); *Perkiomen Valley School District and Boyertown Area School District v. Robert J. Bradbury and Margaret B. Bradbury*, Docket No. 06-06754 (Ct. Com. Pl., Chester Co.); *Red Lion Area School District v. Dolphin & Bradbury and Robert J. Bradbury, et al.*, Docket No. 06-16221 (Ct. Com. Pl., Montgomery Co.); *Red Lion Area School District v. Robert J. Bradbury and Margaret B. Bradbury*, Docket No. 06-19638 (Ct. Com. Pl., Montgomery Co.); *North Penn School District v. Dolphin & Bradbury, Inc. and Robert Bradbury, et al.*, Docket No. 05-11291; and *Red Lion Area School District, et al. v. Dolphin & Bradbury, Inc., et al.,* August Term 2008, No. 03939 (Ct. Com. Pl., Phila. Co.)(hereinafter referred to collectively as the "School District Actions").

4. On November 30, 2009, a final judgment was entered by consent against Bradbury, permanently enjoining him from future violations of Sections 17(a) of the

Securities Act, Sections 10(b) and 15B(c) of the Exchange Act and Rule 10b-5 thereunder, and MSRB Rule G-17, and permanently enjoining him from aiding and abetting violations of Sections 15(c), 15B(c)(1) and 17(a) of the Exchange Act, and Rules 15c2-12, 17a-3 and 17a-4 thereunder, in the civil action entitled Securities and Exchange Commission v. Robert J. Bradbury, et al., Civil Action Number 2:06-cv-3435, in the United States District Court for the Eastern District of Pennsylvania. Bradbury was also ordered to pay, on a joint and several basis with D&B and Margaret B. Bradbury, disgorgement in the amount of $3,405,000, plus prejudgment interest thereon in the amount of $1,731,628.79, provided that the total of such disgorgement and prejudgment interest (*i.e.*, $5,136,628.79) shall be deemed satisfied, at the time the Final Judgment is entered, by the settlement agreement by and between Bradbury and Margaret B. Bradbury, and Boyertown Area School District, North Penn School District, Perkiomen Valley School District, and Red Lion Area School District in the School District Actions. In addition, Bradbury was prohibited from serving as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act.

5. The Commission's complaint alleged, among other things, that D&B and Bradbury defrauded four Pennsylvania school districts by repeatedly selling them, without adequate disclosure, a series of unsuitable, risky, short-term notes issued to finance a speculative golf course in central Pennsylvania. The complaint also alleged that Bradbury, on D&B's behalf, also executed numerous false and misleading documents to conceal the fraud.

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)(4) of the Exchange Act, the registration of Respondent D&B be, and hereby is, revoked.

Pursuant to Sections 15(b)(6) and Section 15B(c)(4) of the Exchange Act, Respondent Bradbury be, and hereby is barred from association with any broker, dealer, or municipal securities dealer.

Any reapplication for registration by Bradbury 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.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61137 / December 10, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3074 / December 10, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13707

In the Matter of **Applied Wellness Corporation,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act"), against Applied Wellness Corporation ("Applied Wellness" or "Respondent").

II.

After an investigation, the Division of Enforcement alleges that:

1. Applied Wellness Corporation (CIK No. 0001134011) is a Nevada corporation located in San Diego, California. Pursuant to its Form 10-KSB filed on April 15, 2008, it purported to distribute "devices for non-invasive therapeutic applications based on the latest advances in the field of ionic therapies" through its subsidiary, Energy Balance Resources, Inc. The common stock of Applied Wellness has been registered with the Commission under Exchange Act Section 12(g) since April 8, 2001. Applied Wellness common stock is quoted on the Pink Sheets operated by Pink OTC Markets Inc. (symbol: AAWL) and is eligible for the "piggyback" exception of Rule 15c2-11 of the Exchange Act.

2. While its common stock was registered with the Commission, Applied Wellness failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-15 thereunder in that it failed to make disclosures in its Form 10-KSB for the fiscal year ended December 31, 2007, filed with the Commission on April 15, 2008, concerning its internal control over financial reporting and disclosure controls and procedures, as required by Items 307 and 308T of Regulation S-B.

3. While its common stock was registered with the Commission, Applied Wellness failed to comply with Exchange Act Section 13(a) and Rule 13a-13 thereunder in that it has not filed any periodic or quarterly reports on Form 10-Q for any fiscal period subsequent to its fiscal quarter ended March 31, 2008.

4. While its common stock was registered with the Commission, Applied Wellness failed to comply with Exchange Act Section 13(a) and Rule 13a-1 thereunder in that it failed to file an annual report on Form 10-K for the fiscal year ended December 31, 2008.

III.

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

A. Whether the allegations contained in Section II are true and, in connection therewith, to afford the Respondent an opportunity to establish any defenses to such allegations; and

B. Whether it is necessary or appropriate for the protection of investors, to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities of the Respondent registered pursuant to Section 12 of the Exchange Act.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondent personally or by certified, registered, or Express Mail, or by other means of verifiable delivery.

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

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 61135 / December 10, 2009

Admin. Proc. File No. 3-13422

In the Matter of the Application of

KIRLIN SECURITIES, INC.
ANTHONY KIRINCIC
and
ANDREW ISRAEL

c/o Isaac M. Zucker
Law Offices of Isaac M. Zucker, PLLC
600 Old Country Road, Suite 321
Garden City, NY 11530

For Review of Disciplinary Action Taken by
FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION – REVIEW OF DISCIPLINARY PROCEEDING

Violations of Securities Laws and Conduct Rules

Manipulation

Failure to Provide Best Execution

Improperly Signing Customer Names to Transactional Documents

Registered broker-dealer, its co-chief executive officer, and its head trader manipulated price of security sold to public investors. Broker-dealer's co-chief executive officer also improperly signed customers' names to transactional documents. Broker-dealer and head trader breached obligation of best execution. *Held*, association's findings of violation are *sustained*, and the sanctions imposed are *modified*.

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APPEARANCES:

Isaac M. Zucker, for Kirlin Securities, Inc., Anthony Kirincic, and Andrew Israel.

Marc Menchel, *Alan Lawhead*, *Carla Carloni*, and *Andrew J. Love*, for FINRA.

Appeal filed: March 26, 2009
Last brief received: July 13, 2009

I.

Kirlin Securities, Inc., formerly a broker-dealer registered with FINRA ("Kirlin" or the "Firm"); Anthony Kirincic, Kirlin's co-chief executive officer; and Andrew Israel, Kirlin's head equity trader, appeal from FINRA disciplinary action.[1] FINRA found that Kirlin, Kirincic, and Israel (together, "Applicants") manipulated the stock price of Kirlin's publicly-traded parent company, Kirlin Holding Corporation ("KILN"), and thereby violated Section 10(b) of the Securities Exchange Act of 1934,[2] Rule 10b-5 thereunder,[3] and NASD Conduct Rules 2120 and 2110.[4] FINRA expelled Kirlin from FINRA membership and barred Kirincic and Israel in all

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1 Kirlin filed a request to withdraw its registration as a broker-dealer in November 2006 and is no longer a FINRA member.

2 15 U.S.C. § 78j(b).

3 17 C.F.R. § 240.10b-5.

4 On July 26, 2007, the Commission approved a proposed rule change filed by National Association of Securities Dealers, Inc. ("NASD") to amend NASD's Restated Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc., or FINRA, in connection with the consolidation of NASD and the member-regulation, enforcement, and arbitration functions of the New York Stock Exchange ("NYSE"). *See* Securities Exchange Act Rel. No. 56146 (July 26, 2007), 91 SEC Docket 517. NASD filed its complaint against Applicants before the consolidation for conduct that allegedly violated NASD Rules 2120 and 2110. As part of the effort to consolidate and reorganize NASD's and NYSE's rules into one FINRA rulebook, NASD Rules 2110 and 2120 (which are otherwise unchanged) are now codified as FINRA Rules 2010 and 2020, respectively. FINRA now litigates the case against Applicants, and references in this opinion to FINRA include, where appropriate, references to NASD.

NASD Rule 2120 (now FINRA Rule 2020) prohibits inducing the purchase or sale of a security by means of "any manipulative, deceptive or other fraudulent device or contrivance." NASD Rule 2110 (now FINRA Rule 2010) requires that members "observe high standards of
(continued...)

capacities for these violations. FINRA also found that Kirincic violated NASD Rule 2110 by falsifying the signatures of his parents on several stock certificates and letters of authorization to facilitate the manipulative scheme, for which FINRA imposed another bar in all capacities. Finally, FINRA found that Kirlin and Israel failed to provide best execution to a customer who sought to sell KILN stock during the manipulation, in violation of NASD Rule 2110, and ordered them to pay, jointly and severally, restitution to the injured customer.[5] We base our findings on an independent review of the record.

II.

This appeal involves findings by FINRA that, during a five-week period in early 2002, after learning that KILN's declining bid price threatened to cause the company to be delisted by Nasdaq, Kirincic, with Israel's assistance, placed more than 100 orders to buy shares of KILN to artificially increase its stock price. FINRA found that Kirincic, whose trades accounted for the vast majority of volume in the thinly-traded KILN, raised KILN's closing bid price over $1.00 for a sustained period and successfully prevented the company from being delisted. In addition, Kirincic admittedly signed his parents' names to certain documents that, among other things, facilitated the transfer of cash to his sister's account to help fund the manipulative purchase orders Kirincic was placing. FINRA further found that Israel, who was involved in Kirincic's scheme to inflate KILN's price, failed to provide best execution to a Kirlin customer who placed an unexpected and substantial order to liquidate his KILN shares that threatened to depress the inflated price of KILN. We turn first to a discussion of the facts surrounding the market manipulation and forgery allegations, and then to the facts regarding the best execution allegation.

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4 (...continued)
commercial honor and just and equitable principles of trade." NASD General Rule 115 (now FINRA Rule 140) provides that persons associated with a member have the same duties and obligations as a member.

5 FINRA found that David Lindner, the other co-CEO of Kirlin Securities, was also liable for failing to give a customer best execution on this trade. FINRA imposed a one-year suspension on Lindner, ordered him to requalify, and found him liable, jointly and severally with Kirlin and Israel, for the restitution owed to the affected customer. FINRA found that Israel's and Kirlin's failure to provide the customer with best execution on his trade also justified one-year suspensions, but it declined to impose them because, "in light of Israel's bar and Kirlin's expulsion for their manipulation, we consider the one-year suspensions . . . redundant."

Lindner initially joined the other applicants in petitioning the Commission for review of FINRA's decision but moved to withdraw his petition on May 20, 2009. Lindner's motion was granted on May 26, 2009. *See Kirlin Sec.*, Order Granting Request to Withdraw Application and Dismissing Review Proceeding Against Applicant Lindner, Admin. Proc. File No. 13422 (May 26, 2009). Accordingly, findings in this opinion with respect to Lindner are made only for the purpose of determining liability as to the remaining applicants.

A. Background

With David Lindner,[6] Kirincic was co-CEO and co-founder of Kirlin. At the Firm, Kirincic's primary role "was to evaluate the [company's] financial matters, to deal with liquidity and to deal with the overall structure of our company . . . ."[7] Israel, who had joined the Firm in 1989, became Kirlin's head equity trader in January 2002. Only one other trader in the office traded in equity securities at the time; he served as Israel's assistant. When Kirincic wanted to place an order to buy or sell securities for his customers' accounts, he would generally call the trading desk and instruct Israel (or Israel's assistant) to enter the order.[8] Israel testified that, when Kirincic called to place an order for his customer, Kirincic specified the price, number of shares, and how to route the order. Israel or his assistant would then write the order ticket and enter it as instructed. Israel testified that, although he was not always the one who received Kirincic's calls, he would nevertheless review all of the trading department's order tickets (including, presumably, Kirincic's) "to make sure there was nothing inappropriate" about them.

Kirlin was at all times relevant to this proceeding a wholly-owned subsidiary of KILN. KILN was incorporated in 1994 by Kirincic and Lindner, who both served as co-chief executive officers and members of the five-person board of directors. KILN has been publicly traded since its listing on the Nasdaq Small Cap Market in 1995. In 1999, the company achieved compliance with the standards set by Nasdaq's National Market ("NNM") and transferred its listing there.[9] Kirincic testified that, "given the choice" between the two market levels, he "would prefer to be on the one that was more highly recognized by the market," and that KILN's move to NNM was "a positive development in the evolution of the company moving forward." A press release issued by the company in 1999 noted that "[t]he prestige and viability of the listing [on] the Nasdaq National Market would enhance the company's accessibility with both the institutional investment community and the financial media."

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6 *See supra* note 5.

7 The Firm employed about 150 registered representatives in its Syosset, New York headquarters and seven branch offices. In 2002, Kirlin maintained more than 26,000 customer accounts, which held over $800 million in assets. Kirincic did not generally manage day-to-day operations of Kirlin, and he handled only about fifty customer accounts, many of which were owned by members of his family.

8 Kirincic testified that he gave orders to "[w]hatever qualified individual in our trading department answered the phone." Israel was that person "some of the times."

9 In 2005, Nasdaq changed the name of its Small Cap Market to the Nasdaq Capital Market. *See* Exchange Act Rel. No. 52489 (Sept. 21, 2005), 86 SEC Docket 906. In 2006, Nasdaq changed the name of its National Market to the Nasdaq Global Market. *See* Exchange Act Rel. No. 53799 (May 12, 2006), 88 SEC Docket 25. We continue to use the designations "Small Cap Market" and "National Market" for purposes of this opinion.

As Applicants acknowledged at the hearing, KILN was a thinly-traded stock: the average daily volume of KILN trading prior to the events at issue was generally less than 10,000 shares. Israel testified that there was "really no outside interest" in KILN shares beyond the interest Kirlin and its customers may have had. KILN's public float in the spring of 2002 was approximately 8.5 million shares held by 193 owners of record;[10] Israel estimated that about eighty percent of the stock was held in accounts serviced by Kirlin. Kirincic himself owned twenty percent of KILN's stock.[11]

B. Nasdaq notifies KILN of possible delisting based on low stock price

Although KILN's stock had once traded at prices as high as $57 or $58 per share, the company reported substantial net losses in 2000 and 2001,[12] and the price of KILN shares declined. By early 2002, KILN's closing bid price dropped below $1.00, the minimum price required to maintain listing on Nasdaq, and remained below that level for thirty consecutive trading days.[13]

As a result, on February 20, 2002, Nasdaq notified KILN that its stock would be delisted from the exchange in accordance with Nasdaq Marketplace Rule 4450(e)(2) unless, within the next ninety calendar days, KILN's bid price closed at or above $1.00 for at least ten consecutive trading days.[14] In its letter, Nasdaq noted that "[u]nder certain circumstances, to ensure the Company can sustain long-term compliance, Staff may require that the closing bid price equals

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[10] In its Form 10-K filing for the year ended December 31, 2001, KILN reported that it believed there were "over 1,500 beneficial owners" of KILN stock.

[11] Lindner also owned 20% of KILN's stock. In 2006, Kirincic came to hold approximately 35% of the company's shares when he agreed to a reduction in salary in exchange for KILN shares. Israel testified that in 2002 his only KILN holdings were options on 10,000 shares that had not yet vested.

[12] Kirincic testified that these losses were due largely to expenses related to the acquisition of other broker-dealers.

[13] Nasdaq Marketplace Rule 4450(a)(5) required that securities maintain a minimum bid price of at least $1.00 for continued inclusion on the Nasdaq market. The closing inside bid of a stock is set by the inside, or highest, bid reflected by a market maker at the close of the market.

[14] Nasdaq Marketplace Rule 4450(e)(2) provided that "[a] failure to meet the continued inclusion requirement for minimum bid price shall be determined to exist only if the deficiency continues for a period of 30 consecutive business days," and that, "[u]pon such failure, the issuer shall be notified promptly and shall have a period of 90 calendar days from such notification to achieve compliance."

$1.00 per share or greater for more than 10 consecutive trading days before determining that the Company complies." The letter also suggested that KILN consider transferring its securities to the Nasdaq Small Cap Market. The Small Cap Market also required listed companies to maintain a $1.00 minimum bid price but offered an extended period within which to regain compliance with that requirement.

C. Kirincic places trades in parents' accounts following delisting notice

Shortly after Nasdaq notified KILN that its low bid price threatened its listing status, Kirincic placed several trades in accounts held at Kirlin by his parents. Although Kirincic did not have formal discretionary authority over these accounts, he testified that he exercised time and price discretion in placing orders to effect his customers' trades "to get the best execution for my customer without impacting the market." On March 5, 2002, Kirincic placed an order with Israel to cross four sell orders (two from his parents' retirement accounts and two from the accounts of his parents-in-law) with a buy order for his parents' joint (non-retirement) account for 140,000 KILN shares at $.85 per share. During the hearing, Kirincic could not recall any details about these transactions or discussions with his parents regarding their reasons for these trades, other than that they served certain unspecified "tax planning" purposes. Despite these trades, KILN's bid price closed at $.80.

From March 7 through March 15, 2002, Kirincic placed several more orders to purchase KILN shares for his parents' joint account, purchasing a total of 10,981 shares in twelve transactions.[15] Kirincic testified that he had no understanding of his parents' strategy in KILN at the time and no recollection of how these orders were executed. Kirincic directed the trading desk to place these orders through the Firm's clearing broker, Bank of New York, which automatically routed the orders to Herzog Heine Geduld ("Herzog"), a market maker in KILN stock.[16] Despite this increase in activity, the price of KILN generally declined through these first two weeks of March, and after the Kirincics' purchases on Friday, March 15, KILN's inside bid price closed at $.64, the lowest closing price since KILN began trading on the NNM in 1999.

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[15] Kirincic's parents purchased 2,800 shares at $.75 on March 7; 500 shares at $.73 on March 8; 100 shares at $.73 on March 11; 581 shares at $.73 and 622 shares at $.71 on March 13; 1,378 shares at $.76 in two transactions on March 14; 2,000 shares at $.6499, 1,000 shares at $.65, and 2,000 shares in three transactions at $.64 on March 15. Kirincic's parents purchased no more KILN shares for this account at least through June 2002, but, as discussed later in this opinion, they sold a total of 385,498 KILN shares back to the company in April 2002.

[16] In addition to Herzog, five other firms made a market in KILN stock. Kirlin, however, was not a KILN market maker.

D. Kirincic changes his trading strategy, and KILN's price increases

The next trading day, Monday, March 18, Kirincic began placing orders to purchase substantial amounts of KILN stock for his sister, Susan Paduano, and would continue to do so through April 22 (the "Trading Period"). Kirincic, who testified that he exercised time and price discretion over Paduano's orders and also determined how to route them in the market, placed most of these orders not through Herzog but through BRUT, an electronic communications network ("ECN"), for execution. A significant feature of trading on ECNs, as Applicants' expert explained, is that, when a broker places an order with an ECN at a price above the highest, or "inside" bid, the ECN automatically displays that bid as its own, creating a new inside bid price that is displayed to the market. According to Applicants' expert, of the 65 orders Kirincic placed for Paduano on the BRUT ECN during the Trading Period, 41 of them were priced at or above the inside bid, and an additional 20 of them were priced at or above the inside ask; more than 93% of Kirincic's orders were therefore responsible for setting a new inside bid. Paduano's KILN purchases would total over $200,000 in a five-week period, account for 43% of the total trading volume in KILN, and increase the price of KILN over 57%.

In March 2002, Paduano was divorced, unemployed, caring for three children, and receiving as income only $3,600 per month in alimony. She nevertheless testified that she gave instructions to Kirincic to purchase shares in large dollar amounts, such as $25,000 or $50,000, depending on what she was "comfortable with" at the time.[17] During the hearing, neither Paduano nor Kirincic could recall specific details about any of the orders she gave Kirincic.[18] Although Paduano had not been an active purchaser of KILN shares in the four years preceding 2002 and had purchased none in January or February 2002,[19] she testified that she wanted to acquire KILN stock because "it was [her] desire to always hold a large position in the company" that her ex-husband (formerly a partner of Kirincic and Lindner) and brother had built. The KILN shares were intended, she said, to be a "legacy for my children." Although each of Paduano's children had a custodial account at another financial institution, all the KILN purchases Paduano made in 2002 were bought through her own account at Kirlin. There is no evidence that Paduano transferred any of the acquired KILN shares to her children's accounts; in

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[17] Paduano testified that her liquid net worth was approximately $500,000, though Kirlin's account documentation reflected a lower figure of $150,000 - $250,000.

[18] There is no written evidence in the record of any of the instructions Paduano gave Kirincic.

[19] She purchased 9,100 shares in 1998, none in 1999 or 2000, and 31,925 in 2001 (which includes a purchase of 10,000 shares that Paduano testified she acquired in a private placement in September 2001). Over the same period, she sold 45,400 shares, making her a net seller of KILN. By the beginning of 2002, Paduano held approximately 167,000 shares of KILN in her account at Kirlin.

fact, as discussed later in this opinion, Paduano sold all the shares she acquired at the end of 2002.

Kirincic did not recall discussing with his sister the wisdom of acquiring substantial amounts of KILN, and Paduano testified that she did not consider news regarding KILN, or the delisting notice it received, when she decided to purchase shares of KILN. Paduano testified that she considered March 2002 to be a good time to acquire KILN because she "had a better cash flow" than in the past. Despite her professed improved cash flow, however, Paduano borrowed substantial amounts from her parents to help finance at least some of these purchases.[20] For example, on April 16, Kirincic effected a transfer of $75,000 from one of his parents' accounts at Kirlin to Paduano's account by means of a letter of authorization to which Kirincic admittedly signed his parents' names.[21] Although Kirincic claims he signed this document, and others discussed later, with his parents' authorization, nothing in the record evidences that authorization.[22]

Kirincic placed his first order for Paduano's account at 9:33 a.m. on March 18, for 7,000 shares (with 500 shares displayed to the market and 6,500 kept "in reserve," *i.e.*, hidden from the market until the displayed portion of the order was filled) at a limit price of $.68 via the BRUT ECN. Because this price was $.01 above the inside ask, Kirincic quickly received a partial fill of about 2,500 shares. An hour later, Kirincic directed that the order for the remaining shares be cancelled and replaced with an order for 4,400 shares (showing 500 with 3,900 in reserve) at $.74 (again, $.01 above the inside ask). Kirincic quickly received a partial fill on 1,500 shares, and the inside market for KILN moved to $.74 - $.76. Less than an hour later, Kirincic directed the remaining order be cancelled. At 1:00 p.m., with the inside market at $.66 - $.76, Kirincic placed another order for 10,000 shares (showing 1,000 with 9,000 in reserve) at $.76. He immediately received a partial fill of 3,000 shares, and the inside market moved to $.76 - $.79. The remainder of this order was filled in increments throughout the afternoon and was completed just before 4:00 p.m. KILN's inside bid price closed at $.68, $.04 higher than the previous day's close.

This pattern of trading activity by Kirincic – *i.e.*, placing an order for several thousand shares (most held in reserve) on the BRUT ECN at a price well above the inside bid (and

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20 Paduano testified that she planned to repay her parents with money her ex-husband owed to her, but offered no explanation as to why she could not wait to purchase the shares until she could afford them without borrowing from her parents.

21 Kirincic also admitted signing his parents' names to six other documents, including two other letters of authorization that transferred a total of $125,000 from his parents to his sister in May and June 2002, and four stock certificates that enabled the transfer of over 465,000 of his parents' KILN shares to KILN as part of its stock repurchase program, described herein, on April 10, April 22, and June 20, 2002. *See infra* notes 29 & 45.

22 *See infra* Section III.B.

sometimes at or above the inside ask), receiving partial fills, and then shortly thereafter cancelling and resubmitting the order at a higher price – characterized his trading for Paduano throughout the Trading Period.[23] Paduano ultimately purchased 224,653 KILN shares in approximately 115 transactions, including 65 orders placed on the BRUT ECN at prices that equaled or exceeded the existing bid and frequently even equaled or exceeded the existing ask, for a total price of $219,952 during the Trading Period. Applicants' expert calculated that the average time lapse between Kirincic's original orders and his subsequent increases in his bid price was just under ninety minutes. The average daily volume during the Trading Period tripled to 32,019 shares per day based almost exclusively on the activity in Paduano's account,[24] compared to 9,904 shares per day from January 1 through March 15, 2002.[25] As discussed below, KILN's closing bid price rose from $.68 on March 18 to as high as $1.15 on April 16, closing at $1.01 at the end of the Trading Period on April 22.

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23 For example, on March 19, Kirincic placed an order for 10,000 shares (showing 1,000 and with 9,000 in reserve) at a price of $.75, which was $.07 above the inside bid and just $.03 below the inside ask. About ninety minutes later, Kirincic cancelled that order and replaced it with one at the inside ask of $.78. He almost immediately received a fill on 5,000 shares. An hour later, Kirincic cancelled that order and replaced it with an order for 5,000 shares (showing 1,000 and with 4,000 in reserve) at $.81. He immediately received a fill on 1,000 shares but cancelled the order ninety minutes later, replacing it at 3:54 p.m. with an order for 4,000 shares (showing 1,000 and with 3,000 in reserve) at $.84. This order received a fill on 100 shares just before the market closed, and Kirincic's outstanding order set the inside closing bid that day at $.84. With Kirincic in the market buying shares for his sister using series of limit orders with increasingly higher bid prices, KILN's inside bid rose from a closing price of $.68 on March 18 to $.85 on March 26.

24 Purchases by Kirlin customers, and trading by other market participants to provide those customers with a supply of KILN stock to purchase, composed more than 90% of the volume of trading of KILN during the Trading Period.

25 A FINRA staff member who participated in the investigation of Applicants' conduct and who testified at the hearing calculated the comparative average daily volume inclusive of all trades in KILN, including the agency cross transactions for Kirincic's parents on March 5 and the stock buyback transactions on April 10 and 22 under KILN's stock repurchase program (discussed later in this opinion) that did not involve Paduano's account. Including these transactions yields a volume before the Trading Period of 15,396 shares per day compared to 56,579 shares per day during the Trading Period: this is an increase of 367%. For purposes of isolating the effect Kirincic's trading on behalf of Paduano had on the market for KILN, we exclude the cross and repurchase transactions which occurred at Kirlin but away from Paduano's account. This yields a change in the average daily volume of 32,019 shares during the Trading Period versus 9,904 prior to the Trading Period, which is an increase of 323%.

E. KILN's Board of Directors considers responses to the Nasdaq delisting letter

While Kirincic was beginning to place substantial orders to buy KILN shares for his sister's account at increasing prices, KILN's board of directors was considering its options for addressing its decreasing share price and the potential delisting notice from Nasdaq. The board, which consisted of Kirincic, Lindner, and three others,[26] met via conference call on March 19 and, according to the minutes of the meeting,

> discussed various actions the Corporation could take to regain compliance and maintain listing on Nasdaq including, exercising its ability to phase down to the Nasdaq SmallCap Market, which provides the Company with lengthier core periods in which to regain compliance with the $1.00 minimum bid price requirement, effectuating a repurchase of the Corporation's stock in the market, or effectuating a reverse stock-split.

The board minutes further note that Kirincic was "hoping the bid price of the Corporation's stock will go above the $1.00 minimum bid price on its own merit."[27] The board took no action at that time but decided to reconvene and discuss the matter further.

On March 27, 2002, KILN's board of directors met again to discuss the company's possible delisting from Nasdaq, as its stock price had still not reached the $1.00 mark. In its Form 10-K for the year ended December 31, 2001, which the company would file a few days after the March 27 meeting, KILN stated that, "[i]f we are delisted from the Nasdaq National Market the liquidity of our common stock may be adversely affected which may result in a decline in our stock price."[28] In order to "regain compliance and maintain listing on Nasdaq," KILN's board authorized a stock repurchase program in which the company agreed to buy back

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26 The three other directors were Edward Casey (Kirlin's counsel); Harold Paul (a securities attorney); and Martin Schacker (the former chairman of a broker-dealer acquired by Kirlin in 2001).

27 The board minutes state that "Kirincic notified the Board that the Corporation had hired a public relations firm," and that this was a source of hope that the stock price would rise. However, Kirincic testified that he did not hire a public relations firm but an investment banking firm, which had written a "small report" about KILN in December 2000. Kirincic explained that KILN "had hoped that in light of the fact that we had some knowledgeable exposure about our company and our desire to acquire other people, that that's where the thought process that the stock might go up over $1.00 on its own merits came from." Kirincic did not recall noticing the inaccuracy in the board minutes. He was not asked to elaborate on why a report written more than a year earlier was expected to affect the price of KILN stock in spring 2002.

28 This statement appeared in the "risk factors" section of the Form 10-K, which disclosed several items that potential investors were encouraged to consider before investing in the company.

up to $1 million of KILN stock. Kirincic and Lindner were given authority to act as brokers on behalf of KILN's account and were given an upper limit of about $1.30 on the price per share KILN would pay.

F. Kirincic's orders increase in size and KILN's closing bid price rises over $1.00

On April 1 and 2, 2002, KILN made two news announcements that, although positive, had no significant impact on the market. After the market closed on April 1, KILN announced its earnings for 2001 and reported that its net loss of $3.6 million for 2001 was significantly less than its reported net loss of $11 million for 2000. The inside bid for KILN nevertheless dropped $.04, to $.73, on the morning of April 2. Later that morning, KILN publicly announced the stock repurchase program that the board had previously authorized on March 27.[29] Again, the market exhibited no significant response.[30]

A few minutes after the announcement of the repurchase plan, Kirincic resumed purchasing shares for his sister, now in amounts substantially larger than before.[31] Paduano testified, however, that she could not recall why the size of her orders increased in April. Paduano's account purchased a total of 12,500 shares through Herzog at prices beginning at $.9479 in the morning and ending at $.99 just before 3:00 p.m.[32] At approximately 3:30 p.m., the inside bid had risen to $.97; Kirincic placed an order for 50,000 shares (showing 2,500 with 47,500 in reserve) at a price of $1.02 ($.02 above the inside ask price) and immediately began receiving fills on 24,800 shares. Three minutes later, at 3:39 p.m., the inside bid had moved to $1.01. Kirincic cancelled the order for the remaining shares and replaced it with an order for 25,000 shares (showing 2,500 and with 22,500 in reserve) at the inside ask price of $1.04. He received a fill on 400 shares before the market closed, still reflecting his outstanding order as the inside bid price. KILN's inside bid closed at $1.04, the first time it had reached the $1.00 mark in three months.

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29 KILN made its first purchase of shares through the repurchase program on April 10, 2002, when it purchased 260,000 shares from Kirincic's parents at a price of $1.02 per share. This price was $.02 less than the current inside bid of $1.04. Kirincic admitted that he signed his parents' names to stock certificates that facilitated the transfer of these shares to KILN. *See supra* note 21.

30 The inside bid moved only $.01, to $.74.

31 Israel was on vacation from April 1 through April 5 and did not assist Kirincic in placing any orders during that period.

32 The record shows that 2,500 of these shares were bought at prices more than $.20 above the inside bid and within $.04 of the inside ask. The remaining 10,000 shares were bought at prices that were at or above the inside ask.

From April 3 through April 17, 2002, Kirincic continued placing orders of significant size for his sister's account at prices that generally increased from a low of $.95 on April 3 to a high of $1.15 on April 16.[33] KILN's inside bid price closed above $1.00 on each of these ten trading days. Throughout the period, Kirincic placed a total of seventeen orders on BRUT ECN, and the purchases he made on behalf of his sister (totaling over 100,000 shares at over $112,000 total cost) accounted for the vast majority of trading volume in KILN. He placed three orders on April 3 for 10,000 shares and one for 25,000 shares on April 5, but the remaining orders were in much larger amounts – 50,000 and 75,000 shares. Consistent with his strategy earlier in the Trading Period, Kirincic generally placed an order at a price above the inside bid, received partial fills, and then replaced the order with one at a higher price.[34]

Also during this period, on April 3, Kirincic placed an order for Paduano on Bank of New York's system, which was routed to Herzog, for 2,000 shares at $1.01. This order was placed just one minute after Kirincic placed an order for 50,000 shares at $1.02 on BRUT ECN. It was entered as "good til cancelled," which meant that the order remained active in the market without expiring until fully executed or cancelled. During the hearing, Kirincic testified that he had no "specific recollection" of why he placed this order while he was already placing large orders through BRUT ECN at higher prices, though he admittedly understood that the effect of doing so would create the appearance that there were two different purchasers of KILN in the market.[35] Kirincic received a fill on 1,000 shares on April 4, but the balance of the order remained active in the market until it was filled thirteen trading days later, on April 22. Kirincic's good til cancelled order therefore set a floor of $1.01 on the inside bid price from April 3 through April 22.

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[33] Although Israel did not discuss Paduano's purchases of KILN stock with Kirincic, Israel testified that he eventually became aware that Kirincic was working a large order for his sister. Israel claimed that Kirincic's trading did not cause him concern, observing that "I have seen Mr. Kirincic put orders in over the years in similar strategies. I have seen other brokers put similar strategies in. Nothing different than I have seen before and after."

[34] For example, on April 16, the inside market opened at $1.04 - $1.10. At 9:42 a.m., Kirincic placed an order for 25,000 shares (1,000 showing and with 24,000 in reserve) at $1.08. At 1:19 p.m., Kirincic cancelled that order and replaced it with one at a price of $1.15 ($.05 above the inside ask). After receiving a partial fill on 700 shares, Kirincic cancelled the order for the remaining shares, replaced it with an order for the same number of shares (24,300) at $1.14, then immediately replaced it again with an order at $1.15. Kirincic received a partial fill on 10,500 shares in five transactions before the market closed. Kirincic's bid of $1.15 caused BRUT to hold the inside bid at the close.

[35] Kirincic later testified, when questioned by the Hearing Panel, that the good til cancelled order "was entered incorrectly and checked off as Good Til Cancel as opposed to a day order because I never enter Good Til Cancel orders."

G. KILN regains compliance with Nasdaq listing requirements

On the morning of April 18, 2002, Nasdaq sent an e-mail to Kirincic noting that KILN's bid price had closed above $1.00 for twelve consecutive days. Nasdaq staff stated that, "[p]rovided the bid price does not close below $1.00 for the next two trading days, on Monday (4/22/02) Staff will issue a formal notice of compliance."

Kirincic placed a few more orders for his sister's account in April after receiving KILN's compliance notice, making purchases for her account totaling 6,200 shares at prices ranging from $1.041 to $1.1489 on April 18 and 22.[36] During subsequent months, Kirincic continued to purchase shares of KILN for Paduano's account, but with less apparent urgency.[37] During the five-week Trading Period, Paduano had purchased a total of 224,653 shares (for a total price of $219,952) on 19 out of 26 trading days;[38] she was therefore buying KILN shares on 73% of the days in the Trading Period with an average purchase of $8,641 per trading day.[39] Following the end of the Trading Period through October 2002, Paduano's account purchased 303,285 KILN shares (for a total price of $228,419) on 59 out of 133 trading days; she was therefore buying KILN shares on only 44% of the remaining days in 2002 with an average purchase of $1,717 per trading day. The price of KILN shares declined along with the frequency of Paduano's purchases. According to data provided by Applicants, KILN's inside bid price closed at or above $1.00 on only four more days in April, two days in May, and one day in June 2002.

On July 30, 2002, KILN received notice from Nasdaq that the stock was again out of compliance with the minimum bid price rule and was given until October 28, 2002 to regain compliance. On August 14, 2002, KILN filed a Form 10-Q for the period ending June 30, 2002, in which it noted that it "will need to phase down to the Nasdaq SmallCap Market," which would

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36 For example, on April 18, Kirincic placed an order through the trading desk to buy 2,500 shares of KILN on BRUT for Paduano's account at a limit price of $1.08 (showing 1,000 shares with 1,500 in reserve). Eight minutes later, Kirincic cancelled that order and replaced it with an order for 25,000 shares at $1.08 (showing 1,000 shares with 24,000 in reserve). Kirnicic received two partial fills on the order totaling 3,900 shares and leaving 21,100 outstanding. At 12:49 p.m., shortly after receiving his last partial fill, Kirincic cancelled the order for the remaining shares. KILN's inside bid closed at $1.04.

37 She purchased a total of only 4,500 shares from April 24 through the end of the month (for a total of 157,300 shares purchased in April) and another 54,850 in May.

38 Paduano was in the market, however, on 23 out of 26 days because her good til cancelled order with a KILN market maker was active from April 3 through April 22.

39 We arrive at this average by dividing the total number of shares Paduano purchased (224,653) by the number of days in the period (26).

extend the deadline for compliance with the $1.00 minimum bid price rule.[40] On October 25, 2002, KILN submitted an application to transfer to Nasdaq's Small Cap Market, which was granted on November 21, 2002.[41]

On December 24, 2002, Paduano sold back to KILN all of the shares she had bought that year: she sold 600,000 shares back to KILN at $.45 per share, for a total sale price of $270,000.[42] When asked why she sold most of her KILN holdings in December, Paduano testified that she was "really extended out there," "was going on a very expensive trip to Europe," and was still waiting for her ex-husband to pay her the money she was owed. She felt she "had to put this dream of my legacy on the back burner . . . ."

On January 6, 2003, KILN effected a one-for-eight reverse stock split, and the company's board of directors announced that it "hope[d] that a higher stock price with fewer shares outstanding will enable our Company to be better received by the marketplace in the future." KILN traded on the Small Cap Market until August 2008, when the company changed its name to Zen Holdings Corp., and is currently quoted in the Pink Sheets.

H. Execution of Lee's order to sell a large block of KILN shares

We turn now to a discussion of the facts regarding FINRA's finding that Israel and Kirlin failed to provide a customer, Daniel Lee, with best execution on his order to sell 114,000 shares of KILN stock. This order was given to Kirlin on April 22, 2002, just as KILN had regained compliance with Nasdaq's listing standards after its bid price had closed at or above $1.00 for fourteen days.

Daniel Lee maintained an account at Kirlin in which he held 114,000 shares of KILN and about 10,000 shares of a few other securities. In the spring of 2002, Lee was being treated for esophageal cancer and was not making or receiving telephone calls.[43] In mid-April, his financial advisors recommended that Lee "consolidate [his] accounts and get rid of some of the small

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40 In this filing the company also stated that phasing down to the Small Cap Market was necessary because it would not be able to meet a new requirement that NNM companies have at least $10 million in stockholders' equity.

41 Transfer to the Nasdaq Small Cap Market extended the deadline to regain compliance with Nasdaq's minimum bid price from 90 days to 180 days, which for KILN resulted in a new compliance deadline of January 27, 2003.

42 After the sale, Paduano had approximately 96,000 shares of KILN remaining in her Kirlin account. She purchased a total of 8,017 more shares in 2003 but none in 2004 or 2005.

43 Lee underwent surgery in March 2002 that made it a "strain" to speak. Lee testified at the hearing that he had made a complete recovery from the disease.

accounts[,] especially those with losing positions and [he would] start to invest into more significant markets." Lee's financial advisor put the request in writing, Lee signed it, and Lee's personal assistant, Christi Diver, faxed the request to Kirlin on April 22 at 1:24 p.m.[44]

By the time Kirlin received Lee's fax, three significant transactions had already taken place that day. As part of KILN's stock repurchase program, KILN purchased 125,498 shares from Kirincic's parents and 114,502 shares from his cousin.[45] Both sales were at a price of $1.05, which was $.04 above the inside bid for Kirincic's parents and, when the second purchase was executed a few minutes later, $.01 above the inside bid for Kirincic's cousin. In addition to these two trades, pending in the market was an order that Kirincic had placed on Paduano's behalf through Kirlin's trading desk to buy 24,700 shares of KILN at $1.10.[46]

The account executive for Lee's account, Patrick Byrne, was working from home that day when he learned about Lee's order to liquidate his account. Byrne attempted to reach Lee by phone at 2:43 p.m., but Diver took the call and informed Byrne that Lee was "incapacitated" and told Byrne to "accept the order as is." Byrne attempted to explain that "this was a very large order and a stock that did not trade a lot of volume. . . . I wanted to talk to [Lee] about maybe placing the order in a different way, in smaller pieces or a way that might not devastate the price that he gets." Bryne testified that Diver "said 'No,' and started to get a little agitated and told me, 'This is the writing, get it done.'" He further testified, "[S]he led me to believe this man was on his death bed."

Byrne called his assistant and told her to write out a market order ticket to sell Lee's shares, without specifying a price per share. At 2:53 p.m., Byrne called Israel to discuss the order. Byrne testified that Israel did not inform Byrne about Paduano's pending purchase order or the repurchases of stock from Kirincic's relatives earlier in the day.[47] According to Byrne, Israel

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44 There is conflicting information in the record as to the time at which Kirlin received the fax from Diver. The electronic transmittal information imprinted by Kirlin's fax machine indicates the firm received the letter at 11:53 a.m.; however, the telephone bill for Lee's fax machine (which, Lee testified, is a dedicated fax line) reflects that a fax was sent to Kirlin at 12:24 p.m. Central Time, which translates to 1:24 p.m. at Kirlin's offices in Syosset. Diver did not testify, and no other information in the record clarifies the issue.

45 Kirincic admitted that he signed his parents' names to a stock certificate that facilitated the transfer of their shares to KILN in this sale. *See supra* note 21.

46 Kirincic's order was originally for 25,000 shares at $1.10 and had already received a fill of 300 shares.

47 Israel admitted that he did not tell Byrne about Paduano's outstanding order, but testified, ambiguously, that "Patrick was aware of the shares in Kirlin earlier that day from the

(continued...)

"was concerned that it was such a large order and what was going on, and I believe at that point he told me he was going to talk to Tony [Kirincic] and see what the price was of this thing." Israel failed to reach Kirincic, who was out of the office that day but spoke instead to Lindner.

Lindner testified that, when he spoke to Israel,[48] Lindner learned that the bid price for KILN at the time "was approximately a dollar a share or somewhere in that area."[49] Lindner knew that KILN had repurchased "$250,000 worth of stock" in the repurchase program earlier in the day, but testified that he did not know the price paid per share and did not know about Paduano's outstanding order to buy KILN shares.[50] Lindner was "nervous" about buying more shares on behalf of KILN without discussing it with others; however, it was late in the afternoon, and Lindner understood from Israel that Lee was "on his death bed and will not be able to make it to the next day and he has to transfer it into the trust." Lindner, who "spent all [his] time on investment banking" for KILN, used his experience in pricing secondary offerings and decided to bid, on behalf of KILN, $.80 per share to repurchase Lee's 114,000 shares.

Israel called Byrne with the $.80-per-share offer and told him that, if he did not like that offer, Israel could put Lee's order into the marketplace. Byrne told Israel to execute the order for $.80, but it was not executed until Byrne's assistant handed Israel the order ticket, some "five to

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47 (...continued)
conversation." The Hearing Panel found that, "[g]iven the ambiguity of Israel's testimony, the clarity and credibility of Byrne's testimony that he was unaware of trading activity in KILN, and the demeanor of the witnesses, . . . Israel did not inform Byrne that KILN had repurchased shares from Kirincic family members that day." The National Adjudicatory Council ("NAC") noted the Panel's finding but did not rely on it for its finding that Israel failed to give Lee best execution.

48 Lindner was out of the office that day. He recalled that he spoke to Pat Byrne on the phone about Lee's order, not Israel. Given that Israel and Byrne both testified that the conversation was between Israel and Lindner, not Byrne and Lindner, we conclude that Lindner's testimony is inaccurate in this regard.

49 Israel testified that he knew generally what the price of KILN was "at most days."

50 Lindner testified that he "was surprised" when he found out that KILN had paid $1.05 for Kirincic's relatives' repurchased shares. However, the Hearing Panel rejected Lindner's testimony and found that he knew when he spoke to Israel that Kirincic's relatives received $1.05 for their shares that morning and also that Paduano was in the market for 24,000 shares at $1.10. The NAC found it unnecessary to determine the credibility of Lindner's assertions because it found that he "should have known" the facts about the market for KILN before he selected a price for Lee's shares.

fifteen minutes" later, at 3:18 p.m.[51] In the meantime, at 3:05 p.m., Israel began selling the shares of other securities Lee held in his Kirlin account. At 3:08 p.m., Kirincic called Kirlin's trading desk and cancelled Paduano's order to buy 24,700 KILN shares at $1.10.[52] Neither Kirincic nor Israel could recall a conversation about the cancellation.[53] At 3:18 p.m., Israel executed Lee's order to sell 114,000 shares of KILN at $.80.[54] Twenty minutes after Lee's trade was executed, Kirincic called the trading desk again and placed a smaller order of 5,000 shares for his sister's account. This order, with a bid price of $1.01, remained unfilled and set the inside bid at the close.[55]

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[51] Byrne understood that the price for a block trade would likely be at a discount from the current market price. He testified that, at the time, he thought $.80 was a "great price" because the trade was for "100,000 shares of a stock that trades hundreds of shares [in daily volume]." Byrne left Kirlin in May 2002 but the record does not suggest his departure was related to these events. FINRA did not charge him with any wrongdoing.

[52] When asked whether he considered crossing Paduano's open order for 24,700 shares with Lee's order to sell, Israel responded that he "couldn't tell you exactly" what his thought process was at the time.

[53] Israel testified that he did not tell Kirincic about Lee's order. However, the Hearing Panel found that, "based upon the circumstantial evidence presented," Kirincic knew about Lee's pending order and cancelled Paduano's pending order based on that knowledge.

[54] When Israel entered Lee's order into the Bank of New York system for execution, he appended a ".w" modifier to the transaction. Under Nasdaq Marketplace Rule 6420, brokers were required to append this modifier when they reported to Nasdaq "transactions occurring at prices based on average-weighting or other special-pricing formulae." *Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Nat'l Assn. of Secs. Dealers, Inc. Relating to Trade-Reporting of Average-Price Trades in Nasdaq-Listed Secs.*, 65 Fed. Reg. 36,482 (June 8, 2000). Nasdaq required use of the modifier for specially-priced transactions in order to "increase pricing transparency and eliminate investor confusion that could occur if investors see prints go across the tape that are unrelated to the current market." *Id.*, 65 Fed. Reg. at 36,483. Israel testified that he did not know why he appended the ".w" modifier to the Lee trade; he did not use the modifier for the earlier agency cross transactions with Kirincic's parents and cousin.

[55] When Lee's financial advisor received a copy of his account statement from Kirlin, he told Lee "there was something strange about this [KILN] trade." On Lee's behalf, the financial advisor unsuccessfully attempted to resolve the dispute with Kirlin over the price Lee received and filed a complaint with FINRA that ultimately led to these proceedings.

III.

A. Manipulation

Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, as well as NASD Rule 2120, make it unlawful for any person to use any manipulative or fraudulent device in connection with the purchase or sale of any security, which includes manipulative trading.[56] We have characterized manipulation as "the creation of deceptive value or market activity for a security, accomplished by an intentional interference with the free forces of supply and demand."[57] Manipulation of the market for securities is at the core of conduct that the securities laws were designed to prevent. Indeed, it "strikes at the heart of the pricing process on which all investors rely [and] attacks the very foundation and integrity of the free market system."[58] We have explained in the past that, "[w]hen investors and prospective investors see activity, they are entitled to assume that it is real activity."[59]

In determining whether a manipulation has occurred, the Commission generally looks to see whether the trading and surrounding circumstances suggest an effort to "interfere[] with the

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56 *Terrance Yoshikawa*, Exchange Act Rel. No. 53731 (April 26, 2006), 87 SEC Docket 2924, 2930-31 & n.19 (*citing Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)). We have previously explained:

> When individuals occupying a dominant market position engage in a scheme to distort the price of a security for their own benefit, they violate the securities laws by perpetrating a fraud on all public investors. In addition, their failure to disclose that market prices are being manipulated not only constitutes an element of a scheme to defraud, but is also a material omission of fact in the offer and sale of securities.

Pagel, Inc., 48 S.E.C. 223, 228 (1985), *aff'd*, 803 F.2d 942 (8th Cir. 1986).

57 *Swartwood, Hesse, Inc.*, 50 S.E.C. 1301, 1307 (1992) (*citing Hochfelder*, 425 U.S. at 199; *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985); *Feldbaum v. Avon Products, Inc.*, 741 F.2d 234 (8th Cir. 1984)).

58 *L.C. Wegard & Co.*, 53 S.E.C. 607, 617 (1998), *aff'd*, 189 F.3d 461 (2d Cir. 1999) (Table). *See also SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1466 (2d Cir. 1996) ("The basic aim of the antifraud provisions is to 'prevent rigging of the market and to permit operation of the natural law of supply and demand.'" (*quoting United States v. Stein*, 456 F.2d 844, 850 (2d Cir. 1972), *cert. denied*, 408 U.S. 922)).

59 *Edward J. Mawod & Co.*, 46 S.E.C. 865, 871 (1977), *aff'd*, 591 F.2d 588 (10th Cir. 1979).

free forces of supply and demand."[60] We have noted that "[p]roof of a manipulation almost always depends on inferences drawn from a mass of factual detail"[61] including "patterns of behavior[] and . . . trading data."[62] We have also observed that manipulations often display several characteristics, including, among other things, a rapid surge in the price of a security, little investor interest in the security, the absence of any known prospects for the issuer or favorable developments affecting the issuer or its business, and market domination.[63]

In order to establish that the manipulative conduct at issue constitutes a violation of Exchange Act Section 10(b) and Rule 10b-5 thereunder, as well as analogous NASD rules, we must also find that Applicants acted with scienter, defined as "a mental state embracing intent to deceive, manipulate, or defraud."[64] A finding that Applicants acted recklessly can satisfy this requirement.[65] Recklessness in this context has been defined as "an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[66]

The evidence demonstrates that Kirincic traded in KILN during the Trading Period, as assisted by Israel, for the purpose of increasing the inside bid price of KILN shares. Kirincic's trading in KILN on behalf of his family displays many of the common characteristics of a manipulative scheme. The price of KILN dramatically increased over the Trading Period, rising from $.68 on March 18 to $1.15 on April 16, closing at $1.01 on the last day of the Trading Period. This is an increase of up to 69% despite the lack of any public news that could explain the change and despite the lack of any significant outside interest in KILN stock. Moreover, the trading Kirincic brokered on behalf of his family accounted for the vast majority of volume in KILN shares during the Trading Period: Paduano's purchases (plus trading in KILN shares by

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60 *Pagel, Inc.*, 48 S.E.C. at 226 (*citing U.S. v. Stein*, 456 F.2d 844, 850 (2d Cir. 1972).

61 *Id.*

62 *Amr Elgindy*, 57 S.E.C. 431, 438 (2004), *aff'd sub. nom., NASD v. SEC*, 431 F.3d 803 (D.C. Cir. 2005) (*citing Brooklyn Capital & Sec. Trading, Inc.*, 52 S.E.C. 1286, 1290 (1997)).

63 *Elgindy*, 57 S.E.C. at 439 (*citing Brooklyn Capital*, 52 S.E.C. at 1290, and *Michael J. Markowski*, 54 S.E.C. 830, 834 (2000), *reconsid. denied*, 54 S.E.C. 957)).

64 *Hochfelder*, 425 U.S. at 193 n.12.

65 *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107 (2d Cir. 1998) (finding allegation of reckless participation in a market manipulation sufficient to state a claim of violation of Exchange Act Section 10(b)).

66 *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977).

other market participants that was necessary to fill her orders) represented 43% of all trading in KILN. The figure climbs to 79% when including KILN's repurchases from Kirincic's parents and cousin. We find KILN's dramatic movement in price, unexplained by other legitimate market forces and considered along with Kirlin's domination of the market for KILN, constitute compelling evidence that Kirincic manipulated the market for KILN.[67]

The specific pattern of trading Kirincic used also strongly suggests fraud. Kirincic learned in late February 2002 that KILN faced delisting from the NNM. Shortly thereafter, in early March, he placed several trades for his parents with a KILN market maker that did not increase KILN's closing bid price. The day after KILN's bid price closed at a historic low despite his parents' purchases, Kirincic began placing orders for his sister's account using a different strategy – placing orders on an ECN at a price above the inside bid (often well above the inside bid), and cancelling and re-entering the order at increasingly higher prices even after his lower bids had generated market interest.[68] On April 2, as KILN's bid price approached $1.00 for the first time in months, Kirincic began placing substantially larger orders for his sister – orders of a size that dwarfed the normal daily volume for the stock – while continuing to enter increasingly higher bids. According to Applicants' exhibits, Kirincic's orders set a new inside bid or equaled the inside bid more than 90% of the time during the Trading Period and were placed at or above the inside ask more than 30% of the time. This kind of price leadership, especially for the stock of a company dealing with substantial financial losses, declining stock prices, and potential delisting from the Nasdaq, is a "classic element[]" of manipulation.[69]

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[67] *See Brooklyn Capital & Sec. Trading, Inc.*, 52 S.E.C. 1286, 1290 (1997) (finding market manipulation where there was "a rapid price surge dictated by the firm that controlled the security's market, little investor interest, an abundant supply, and the absence of any known prospects for the issuer or favorable developments affecting it" (*quoting Patten Sec. Corp.*, 51 S.E.C. 568, 573 (1993))); *Pagel, Inc.*, 48 S.E.C. at 227-28 (finding market manipulation where "individuals occupying a dominant market position engage[d] in a scheme to distort the price of a security" and noting that the stock's price change was not shown to result from "general economic conditions" nor was "related to the market for the company's stock").

[68] *See Yoshikawa*, 87 SEC Docket at 2933-34 & n.31 (rejecting argument that "there is nothing inherently manipulative or fraudulent in entering orders and cancelling them shortly thereafter, and finding that "mass of factual details" established that applicant "engaged in a manipulative scheme by artificially moving the [national best bid or offer] in the specified securities and thereby fraudulently affected the nature of the market for these securities.") (*citing Keith Springer*, 55 S.E.C. 632, 642 (2002)).

[69] *SEC v. Resch-Cassin & Co.*, 362 F. Supp. 964, 978 (S.D.N.Y. 1973); *Dlugash v. SEC*, 373 F.2d 107, 109 (2d Cir. 1967) (noting existence of a manipulative scheme where the condition of the company whose stock was sold at inflated prices was "not favorable," there was "no demand" for the stock, and "rapidly rising prices in the absence of any demand are well-known symptoms of such unlawful market operations").

Kirincic's intent to move the price of KILN upward is further supported by the circumstances surrounding his purchases. KILN's board of directors, of which Kirincic was a member, consistently declared in its meeting minutes and public filings that it considered its listing on the NNM to be important, noting in a 10-K filing that delisting could "adversely affect" the company's liquidity and depress its stock price. Kirincic himself conceded that, "[g]iven the choice of being on either [National or Small Cap Market], I would prefer to be on one that was more highly recognized by the market." Moreover, even if the company would ultimately have to phase down to the Small Cap Market because it could not maintain the shareholder equity requirements of the National Market, KILN still needed to maintain a $1.00 minimum closing bid price to qualify for Nasdaq's Small Cap market. Kirincic was also a significant holder of KILN stock, and, although he himself never sold his holdings, Kirincic's parents and cousin sold substantial amounts of KILN stock back to the company in its repurchase program and received an inflated price for their shares.

We also find that the record establishes that Israel, who placed or reviewed many of Kirincic's orders and who admitted that he was aware that Kirincic was making significant purchases for his sister, was at least reckless in his participation in the scheme. Israel had been with Kirlin for over twelve years and had been promoted to head equity trader in 2002, shortly before the period at issue. He testified that he knew KILN was thinly traded, knew most of the float was held in accounts at Kirlin, and was generally aware of KILN's price movements. Yet, as he admitted, he never questioned Kirincic about his trading despite its many suspicious features. Given these facts, we conclude that Israel knew, or must have known, that Kirincic's trading strategy – *i.e.*, placing orders above the inside bid, cancelling them (often after receiving partial fills) and replacing them with orders with successively higher bids – had the effect of artificially driving up the price of KILN shares. Although the record suggests that Kirincic, and not Israel, directed the placement of the manipulative purchase orders, this does not absolve Israel of responsibility for the part he recklessly played in the scheme.[70]

Applicants argue that they did not engage in manipulation and that, rather, "[t]he trading pattern exhibited by Kirlin's purchases for the Paduano account is consistent with a prudent accumulation strategy designed to minimize the affect [sic] on KILN's market price and to acquire large amounts of stock at better prices." However, neither Kirincic nor Paduano could adequately or credibly explain the reasons for his trading on her behalf: the National Adjudicatory Council ("NAC") accepted the Hearing Panel's finding that "Kirincic's attempts to explain the trading in [Paduano's] account, his claim that [Paduano] directed and initiated the

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[70] *See, e.g., John Montelbano*, 56 S.E.C. 76, 91-92 (2003) (stating that "[a] trader's manipulative activity cannot be excused because it was dictated by others" (*citing Jeffrey D. Field*, 51 S.E.C. 1074, 1076 (1994))); *Hibbard, Brown & Co.*, 52 S.E.C. 170, 180 (1995) (rejecting applicant's argument that he was merely a trader performing his duties and taking orders from his superior and finding that applicant's position as head trader, his "many years of experience," and his intimate involvement in the mechanics of the scheme put him "on notice" that the firm was charging excessive markups).

purchases in her account, and [Paduano's] explanation that the increased trading in her account was meant to leave a legacy of Kirlin Holding stock for her children were not credible." We, too, find no basis to disturb FINRA's rejection of Kirincic's and Paduano's explanation of the trading in her account.[71]

Applicants further assert that "[t]he manner in which Mr. Kirincic placed orders through BRUT allowed him to obtain lower prices for Ms. Paduano. If the total size of the orders had been exposed, the market might have viewed that order differently and could have been more aggressive in its pricing. In this case, the orders entered by Mr. Kirincic did not drive the price up." However, the record evidence demonstrates otherwise. With Paduano as the only significant participant in the market during the Trading Period, excluding the other repurchase transactions by Kirincic's parents and cousin, and with no other market developments or news that had any apparent effect on the market for KILN, the price of KILN rose from a near historic low of $.68 to as high as $1.15. This price change occurred while Kirincic was placing orders for Paduano that habitually set new inside bid prices.[72] Moreover, although Kirincic did not show the entire amount of his order when he placed orders on BRUT, his pricing strategy – entering orders well above the inside bid, receiving partial fills, and shortly thereafter re-entering the order at a higher price – is inconsistent with a strategy to obtain the best price for Paduano. Kirincic's willingness to bid increasingly higher prices without waiting long for the market to come to him suggests an urgency to his acquisition of stock that neither he nor his sister could explain.[73] Moreover, Applicants fail to explain how Paduano's eventual liquidation in December 2002 of all the shares she acquired that year is consistent with her professed legitimate acquisition strategy.

Applicants also argue that "the trade data shows support for the market when Kirlin had no ECN orders pending as well as activity not involving the firm. This is further evidence that the price of KILN was set as a result of the independent judgments of the various market makers

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[71] As we have noted in previous decisions, the credibility determination of an initial fact finder is entitled to considerable weight and deference because it is based on hearing the witnesses' testimony and observing their demeanor. *See, e.g.*, *Rita J. McConville*, Exchange Act Rel. No. 51950 (June 30, 2005), 85 SEC Docket 3127, 3136 n.21, *petition denied*, 465 F.3d 780 (7th Cir. 2006). Such determinations generally "can be overcome only where the record contains substantial evidence for doing so." *Laurie Jones Canady*, 54 S.E.C. 65, 78 (1999) (*citing Anthony Tricarico*, 51 S.E.C. 457, 460 (1993), *petition denied*, 230 F.3d 362 (D.C. Cir. 2000)). As noted, we do not find the record contains such evidence here.

[72] As noted, Applicants' own expert calculated that, of the 65 orders Kirincic placed on BRUT for Paduano, 41 of them were entered at or above the inside bid, and 20 were entered at or above the inside ask.

[73] Indeed, as Applicants' expert noted in the trade data reports he produced for this case, the average time that lapsed between Kirincic's increases in the prices of his orders was only ninety minutes.

providing a market and liquidity in the security." Again, the record evidence demonstrates otherwise. As noted, transactions by Kirincic's family members accounted for 79% of the trading in KILN during the Trading Period. Although there were five days during the Trading Period when Kirincic did not place orders on BRUT while the bid price still remained over $1.00, the April 3 good-til-cancelled order for 2,000 shares at a limit price of $1.01 (which received a partial fill on April 4) was pending with Herzog and supported the price on all of those days. Moreover, after the Trading Period, when Kirincic was no longer making frequent purchases for Paduano, the price of KILN dropped dramatically and steadily declined. The record does not support Applicants' argument, therefore, that the market supported a price over $1.00 for KILN during the Trading Period without Kirincic's intervention.[74]

Applicants argue that at least one district court has held that, in open market transactions in which "the beneficial ownership of the securities change and the volume of trading reflects actual market activity," the Commission "must prove that but for the manipulative intent, the defendant would not have conducted the transaction."[75] Moreover, Applicants argue, "if a securities transaction was made 'for an investment purpose,' then 'there is no manipulation, even if an increase or domination in price was a foreseeable consequence of the investment.'"[76] As discussed, the Hearing Panel that observed their demeanor did not credit the testimony of Kirincic and Paduano that Kirincic placed trades in Paduano's account "for an investment purpose," *i.e.*, as part of a legitimate strategy to acquire KILN shares as a legacy for Paduano's children,[77] and we have acceded to that determination. In addition, Paduano's subsequent liquidation of KILN shares in December 2002 further contradicts her stated "investment

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[74] Noting that FINRA's expert's testimony was ultimately stricken from the record because he became too ill to complete his testimony, Applicants suggest that FINRA could not, and we cannot, draw a conclusion that a manipulation occurred without express expert testimony making such a finding. We disagree, because neither we nor NASD is hindered by the lack of, or is bound by, expert testimony. *See Meyer Blinder*, 50 S.E.C. 1215, 1222 n.32 (1992) ("[T]he absence of expert testimony or the fact that only one party has offered such evidence is hardly dispositive. As we have previously noted, the NASD itself is an expert body whose 'businessman's judgment' may be brought to bear in reaching its decision."); *Gregory M. Dearlove*, Exchange Act Rel. No. 57244 (Jan. 31, 2008), *aff'd*, 2009 U.S. App. LEXIS 16602 (D.C. Cir. July 24, 2009) ("The Commission may consider expert testimony, but it is not bound by such testimony even where it is available.") As discussed above, there is ample evidence in this case, including exhibits, data, and analysis provided by Applicants, as well as Applicants' own testimony, to support FINRA's finding that Applicants engaged in market manipulation.

[75] *SEC v. Masri*, 523 F. Supp. 2d 361, 367 (S.D.N.Y. 2007).

[76] *Quoting United States v. Mulheren*, 938 F.2d 364, 368-69, 372 (2d Cir. 1991).

[77] *See Swartwood, Hesse*, 50 S.E.C. at 1307 (rejecting respondent's argument that he did not manipulate the market and finding that "the pattern of [respondent's] trading contradicts his contention that his objective was merely the long-term accumulation of [the affected] stock").

purpose." Moreover, the Commission has consistently held that an applicant's scienter renders his interference with the market illegal,[78] and this understanding of the antifraud provisions has been explicitly ratified by at least one reviewing court.[79]

We conclude, therefore, that Kirincic manipulated the market for KILN and that Israel, who entered or reviewed all of Kirincic's orders excepting one week in April, was at least reckless in his participation in the scheme. Based on Kirincic's and Israel's conduct, Kirlin is also liable for the manipulation.[80] We affirm FINRA's finding that Kirincic, Israel, and Kirlin thereby violated Exchange Act Section 10(b), Exchange Act Rule 10b-5, and NASD Rules 2120 and 2110.[81]

B. Improperly signing customer names to transactional documents

FINRA charged that Kirincic violated NASD Rule 2110 when he signed his parents' signatures to four stock certificates and three letters of authorization "in disregard of: (a) NASD's Conduct Rules that prohibit that behavior and (b) Kirlin's written supervisory procedures that

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[78] *See, e.g., Yoshikawa*, 87 SEC Docket at 2931 (defining manipulation as "intentional interference with the free forces of supply and demand"); *Pagel, Inc.*, 48 S.E.C. at 226 (same); *Vladlen "Larry" Vindman*, Exchange Act Rel. No. 53654 (Apr. 14, 2006), 87 SEC Docket 2626, 2634 & n.24 (defining manipulation as "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities"); *Robert J. Setteducati*, Exchange Act Rel. No. 48759 (Nov. 7, 2003), 81 SEC Docket 2223, 2230-31 & n.22 (same).

[79] *See Markowski v. SEC*, 274 F.3d 525, 528-29 (D.C. Cir. 2001) (discussing arguments against making manipulation illegal where respondent's legitimate purposes coexist with fraudulent purposes, and concluding that "[w]hatever the practical concerns, we cannot find the Commission's interpretation [of Exchange Act Section 10b-5 as prohibiting manipulation based on intent] to be unreasonable in light of what appears to be Congress's determination that 'manipulation' can be illegal solely because of the actor's purpose").

[80] *See SIG Specialists, Inc.*, Exchange Act Rel. No. 51867 (June 17, 2005), 85 SEC Docket 2679, 2692 & n.35 ("It is well established that a firm may be held accountable for the misconduct of its associated persons because it is through such persons that a firm acts."); *Kirk A. Knapp*, 50 S.E.C. 858, 860 n.7 (1992) (noting that NASD properly attributed scienter of firm's owner to firm and thereby found primary antifraud violation by firm based on owner's conduct) (*citing SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1096-97 nn.16-18 (2d Cir. 1972)).

[81] It is well established that a violation of a Commission or NASD rule or regulation is inconsistent with just and equitable principles of trade, and is therefore also a violation of Rule 2110. *Frank Thomas Devine*, 55 S.E.C. 1180, 1192 n.30 (2002).

specifically prohibit employees from signing documents on behalf of customers."[82] During his investigative testimony, Kirincic originally denied signing his parents' names to these documents, asserting that his parents signed the documents themselves; however, after an off-the-record consultation with counsel, Kirincic then admitted signing their names but claimed that he had their authorization to do so. Kirincic argues that FINRA has not established that he lacked such authorization. FINRA argues, in turn, that Kirincic, whose testimony regarding his parents' permission to sign the documents was rejected by the Hearing Panel, did not establish that he had authorization.

Kirincic's claim that his parents authorized him to sign the documents is uncontroverted, though also unsupported, by any other evidence, with the exception of a letter apparently written and signed by Kirincic's parents that Applicants produced for the first time with their opening brief to the Commission. This letter, dated February 6, 2008, states that "[t]he transactions that took place in our account during 2002 relating to the transfer of Kirlin Holding Corp. stock certificates back into our account and the transfer of monies to Susan Paduano, our daughter, was fully authorized by us and you [*i.e.*, Kirincic] acted on our verbal instructions."[83]

Under Commission Rule of Practice 452,[84] we may permit the admission of additional evidence where the evidence is material and where there exist reasonable grounds for failing to produce the evidence earlier. However, Applicants have not adequately explained their failure to adduce the letter before now. Applicants claim that they "chose not to impose on Kirincic's parents" to appear as witnesses regarding the forgery because they believed that FINRA "failed to meet its burden of proof." However, we have held that an applicant's unsuccessful litigation strategy "does not warrant reopening the record."[85] Applicants concede that they understood the Hearing Panel's decision at least "intimated" that it did not accept Kirincic's testimony that his parents authorized him to sign the documents at issue, and Kirincic's parents executed their letter more than a year before the NAC issued its decision. Applicants have not explained why, regardless of their decision not to call Kirincic's parents as witnesses, they did not offer into

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[82] The Firm's procedures provided that "[e]mployees are not permitted to sign documents on behalf of customers, even when doing so is meant to accommodate a customer's request. Customer signatures must be original by the customer on all documents."

[83] This letter is notarized but does not purport to be sworn under oath or affirmation as is required of testimony given by persons subject to FINRA's jurisdiction. *See* FINRA Rule 9262.

[84] 17 C.F.R. § 201.452.

[85] *Russo Secs., Inc.*, 55 S.E.C. 58, 78 (2001). *See also David T. Fleischman*, 43 S.E.C. 518, 522 (1967) ("Public policy considerations favor the expeditious disposition of litigation, and a respondent cannot be permitted to gamble on one course of action and, upon an unfavorable decision, to try another course of action.")

evidence before the NAC the letter that had already been executed. Therefore, we have not considered this letter in deciding Kirincic's liability.[86] In any event, we find that Kirincic's signing of the documents violated Rule 2110, regardless of whether Kirincic's parents authorized him to sign the documents at issue, as explained below.[87]

NASD Rule 2110 requires that NASD members (and, through NASD Rule 115, associated persons) "observe high standards of commercial honor and just and equitable principles of trade." It is well established that a violation of other NASD rules or securities laws or regulations also constitutes a violation of Rule 2110.[88] However, in the absence of a violation of another securities rule or law, conduct may violate Rule 2110 if it is "unethical" or committed in "bad faith."[89] In order to prove that Kirincic violated the rule, FINRA therefore must show

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86 *See CMG Institutional Trading, LLC*, Exchange Act Rel. No. 59325 (Jan. 30, 2009), 95 SEC Docket 13802, 13809 & n.20 (determining not to adduce into the record documents proffered by applicants not admitted into the record before FINRA and unaccompanied by a motion showing, as Rule 452 requires, "with particularity that the evidence is material and that there were reasonable grounds for the failure to adduce such evidence previously").

87 Both parties argue that the other bore the burden of proving (or disproving) that Kirincic had authority to sign the documents at issue. In doing so they focus on criminal forgery cases, namely *United States v. George*, 386 F.3d 383 (2d Cir. 2004), and *United States v. West*, 666 F.2d 16 (2d Cir. 1981). However, we do not find these cases instructive because criminal forgery requires proof of specific intent, *see U.S. v. Brantley*, 786 F.2d 1322, 1329 (7th Cir. 1986), *cert. denied* 477 U.S. 908, whereas a violation of Rule 2110 does not require any showing of scienter. *Dane S. Faber*, 57 S.E.C. 297, 308 & n.19 (2004). As always, the burden of proving that an applicant engaged in conduct violating Rule 2110 rests with FINRA; however, as we have stated previously, the applicant bears the burden of producing evidence to support his claimed defenses. *James M. Bowen*, 51 S.E.C. 1152, 1154 n.9 (1994) (stating that, although applicant bore the burden of producing evidence to support his purported defense, "[t]he burden of proof [ultimately] remains with the NASD" to establish a violation of its rules); *see also Mark David Anderson*, 56 S.E.C. 840, 855-56 & n.41 (2003) (finding same). As explained herein, we find FINRA met that burden.

88 *See supra* note 80.

89 *Thomas W. Heath, III*, Exchange Act Rel. No. 59223 (Jan. 9, 2009), 94 SEC Docket 13242, 13246 (discussing New York Stock Exchange Rule 476(a)(6), which contains an identical formulation of the "just and equitable principles" or "J&E" rule found in NASD Rule 2110), *aff'd*, No. 09-0825-ag, 2009 U.S. App. LEXIS 24128 (2d Cir. Nov. 4, 2009). We have explained that Rule 2110, and equivalent J&E rules in use by other self-regulatory organizations, "incorporates 'broad ethical principles,' and focuses on the 'ethical implications of the [a]pplicant's conduct.'" *Id.* at 13248 & nn.10-11 (*quoting Peter Martin Toczek*, 51 S.E.C. 781,

(continued...)

that he not only signed his parents' signatures to the documents at issue, but also that he did so unethically or in bad faith.

We find that Kirincic acted unethically when he signed his parents' names to the documents. First, Kirincic signed the documents in direct violation of Kirlin's written supervisory procedures, which prohibit Kirlin employees from signing any documents for customers, even with their express permission. The Commission has, in the past, "looked to internal firm compliance policies to inform our determination of whether applicants' conduct . . . violated the professional standards of ethics covered by [Rule 2110]."[90] Here, Kirlin's rule is aimed at ensuring the Firm's customers are protected against unauthorized transactions in their accounts by requiring that all documentation be completed by the customers themselves, with their demonstrated consent and approval. Kirincic's signing of the documents, at best, unacceptably placed administrative convenience above the integrity of customer assets.[91]

However, Kirincic's conduct not only violated a Firm policy rooted in the protection of customers, it also furthered his fraud on the market for KILN shares. One of the letters of authorization Kirincic signed transferred $75,000 in cash from Kirincic's parents' account at Kirlin to Paduano's account, which Paduano admitted was used, at least in part, to fund the

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89 (...continued)
788 n.14 (1993); *Robert E. Kauffman*, 51 S.E.C. 838, 839 n.5 (1993); *William F. Rembert*, 51 S.E.C. 825, 826 n.3 (1993); *Timothy L. Burkes*, 51 S.E.C. 356, 360 (1993), *aff'd*, 29 F.3d 630 (9th Cir. 1994) (Table); *Ben B. Reuben*, 46 S.E.C. 719, 722 n.7 (1976)).

90 *Heath*, 94 SEC Docket at 13253 & n.21 (*citing Dan Adlai Druz*, 52 S.E.C. 416, 425 (1995) (finding that the respondent violated the J&E rule by settling customer complaints without notifying the legal department when such action violated firm policy), *aff'd*, 103 F.3d 112 (D.C. Cir. 1996) (Table); *see also, e.g., Thomas P. Garrity*, 48 S.E.C. 880, 884 (1987) (finding that failure to adhere to limits on trading of options under the firm's compliance policy violated the J&E Rule).

91 *See William J. Murphy*, 54 S.E.C. 303, 307 & n.5 (1999) (finding violation of J&E rule where broker failed to obtain prior written authorization for trades from client and firm, which was not a violation of a specific rule of the Chicago Board Options Exchange but was a violation of firm's written procedures, and noting that compliance with the firm's rule was "important to assure a firm that the trading is being done with the consent of the customer and to alert the firm that extra oversight of the sales representative's handling of the account may be necessary to protect against improper or unsuitable trading."); *John F. Lebens*, 52 S.E.C. 606, 608 (1996) (finding that broker violated J&E rule by improperly allocating losing personal trades to proprietary accounts of his firm, which had lax internal controls, and noting that "[i]t is important that broker-dealers conduct their business operations with regularity and that their records accurately reflect those operations; it is unethical conduct for their employees to take advantage of loose internal controls to prevent achievement of these principles").

purchases of KILN shares during the Trading Period.[92] Three of the stock certificates that Kirincic signed facilitated the transfer of KILN stock from Kirincic's parents to KILN when they sold over 385,000 shares to the company at artificially high prices during the Trading Period.[93] Kirincic's signatures on the documents – which he initially denied were his – were not merely an innocent administrative convenience but rather facilitated Kirincic's manipulative transactions. We therefore affirm FINRA's finding that Kirincic's conduct was inconsistent with just and equitable principles of trade.[94]

C. Best execution

We now turn to FINRA's finding that Israel, and, through Lindner and Israel, Kirlin, violated NASD Rule 2320(a) in failing to give Lee "best execution" on his order to liquidate his

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[92] The remaining two letters of authorization transferred a total of $125,000 to Paduano's account in May and June 2002; it is unclear what role these funds may have had in the purchases of KILN that Paduano made.

[93] Although Applicants argue that no rule violation can be found here because there is no evidence that Kirincic's parents (who sold KILN stock back to the company at artificially inflated prices during the Trading Period) were harmed by the forgery, we have held that FINRA's authority to enforce its rules "is independent of a customer's decision not to complain." *Maximo Justo Guevara*, 54 S.E.C. 655, 664 & n.18 (2000) (*citing Bernard D. Gorniak*, 52 S.E.C. 371 (1995); *Ronald J. Gogul*, 52 S.E.C. 307 (1995)), *petition denied*, 47 Fed. Appx. 198 (3d Cir. 2002) (Table). In addition, we have found that an applicant may violate Rule 2110 not only where the misconduct defrauds a customer but also where it otherwise benefits the wrongdoer. *Geoffrey Ortiz*, Exchange Act Rel. No. 58416 (Aug. 22, 2008), 93 SEC Docket 8977 (finding broker, who signed customers' initials to account applications without their consent, stood to benefit from misconduct by increasing his compensation while also defrauding customer, and thereby violated J&E rule).

[94] *See James A. Goetz*, 53 S.E.C. 472, 477 (1998) (finding that broker's "misconduct," which included disregarding the rules of his firm's charitable organization and misleading the organization, "reflects directly on [his] ability both to comply with regulatory requirements fundamental to the securities business and to fulfill his fiduciary responsibilities in handling other people's money" and thereby was inconsistent with just and equitable principles of trade). *Accord, e.g., Mark F. Mizenko*, Exchange Act Rel. No. 52600 (Oct. 13, 2005), 86 SEC Docket 1515 (finding broker violated NASD Rule 2110 when he admittedly signed someone else's name to a document without permission or authority to do so and where doing so resulted in exposure of firm to liability without its knowledge); *Eliezer Gurfel*, 54 S.E.C. 56 (1999), *petition denied*, 205 F.3d 400 (D.C. Cir. 2000) (finding broker violated NASD Rule 2110 where record evidence, including other witness's testimony, demonstrated that applicant signed documents without permission despite his denial of wrongdoing, and where doing so resulted in conversion of funds due his firm).

KILN shares.[95] Rule 2320(a) requires that FINRA members and associated persons must "use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions." In determining whether a broker has used "reasonable diligence," FINRA considers, among other things: (1) the character of the market for the security, *e.g.*, price, volatility, relative liquidity, and pressure on available communications; (2) the size and type of transaction; (3) the number of markets checked; and (4) accessability of the quotation.[96]

In finding Applicants liable, FINRA held that "[t]he record is devoid of any evidence demonstrating that either Lindner or Israel was diligent in seeking the most favorable price for [Lee] under the circumstances."[97] We agree with FINRA that Israel, who "was the only person during the afternoon of April 22, 2002, with instant access to market information and a complete picture of the trading that had occurred earlier in the day," did not apply reasonable diligence to obtain the best price for Lee.

Israel admitted that, when he learned of Lee's order to liquidate his KILN holdings, he was aware of Paduano's pending order to buy 24,700 shares at $1.10. Yet he also admitted that he did not disclose this information to Lee's broker, Byrne, or to Lindner. Israel did not

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[95] It is well established that brokers owe their customers a duty of best execution, which requires broker-dealers to execute customers' trades at the most favorable terms reasonably available under the circumstances, *i.e.*, at the best reasonably available price. *See Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 270-73 (3rd Cir. 1998) (noting that the duty of best execution derives from the "mutual understanding that the client is engaging in the trade – and retaining the services of the broker as his agent – solely for the purposes of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal"); *Report of the Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess. Pt. II, 624 (1963) ("[T]he integrity of the [securities] industry can be maintained only if the fundamental principle that a customer should at all times get the best available price which can reasonably be obtained for him is followed.").

[96] NASD Rule 2320(a). A fifth factor, "the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member," was added to the rule effective November 8, 2006.

[97] FINRA concluded that Lindner "should have known that[,] at the time he arbitrarily selected a price of $.80 per share for [Lee's] sell order," KILN's inside bid price was $1.04, KILN had just purchased shares from Kirincic's relatives at $1.05, and Paduano had an outstanding order to buy shares at $1.10. Because, as noted *supra* note 5, Lindner withdrew his application for review of these proceedings, we do not address FINRA's findings as to him.

immediately begin liquidating Lee's position, as the customer instructed,[98] and did not cross Lee's order with Paduano's, but, instead, appeared to delay the execution until after Kirincic cancelled Paduano's $1.10 buy order. Nor did he attempt to inquire whether Kirincic's sister might be interested in acquiring more of Lee's shares, even though he was aware that Paduano had been making large purchases of KILN in her account for several weeks. Instead, Israel, who knowingly or recklessly had been participating in Kirincic's scheme to artificially increase KILN's bid price, and who testified that he understood that a market order as large as Lee's could significantly depress KILN's bid price, ignored Paduano's pending order and sought a price for Lee's shares away from the market.[99] Under the circumstances, we find that Israel, and through Israel, Kirlin, violated NASD Rules 2320(a) and 2110.[100]

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[98] *See Brown & Co.*, 43 S.E.C. 490, 495 (1967) ("A broker receiving a market order from his customer . . . cannot delay execution for such periods of time but must execute reasonably promptly and be in a position to report the details to the customer . . . without undue delay.").

[99] *See Bateman Eichler*, 47 S.E.C. 692, 694 n.5 (1982) ("We have repeatedly held that, in the absence of a clear understanding or indication to the contrary, trade custom requires a dealer to consummate transactions with customers promptly and to charge prices that are reasonably related to the prevailing market price." (*citing Carl J. Bliedung*, 38 S.E.C. 518, 521 (1958); *Lewis H. Ankeny*, 29 S.E.C. 514, 516 (1949))). As noted, Israel appended a modifier to the Lee transaction indicating that the trade was executed based on a special pricing formula. *See supra* note 54.

[100] Applicants' briefs filed with the Commission make no arguments with respect to Israel's and Kirlin's best execution violation. However, in Israel's post-hearing brief, he argued that "there is no evidence that . . . Mr. Lee would have done any better than an average price of $.80" if Israel had crossed Lee's order with Paduano's. A violation of a broker's duty of best execution does not require proof that the customer would have received a better price if the broker had fulfilled his duty; it requires proof that the broker failed to use reasonable diligence to acquire the best price. We find that the evidence demonstrates that, regardless of the price Lee received, Israel – motivated to support Kirincic's scheme to prop up KILN's price – failed to explore an obvious source of interest for Lee's shares in the market and thereby failed to apply reasonable diligence to get the best price for Lee.

Israel also asserted in his post-hearing brief that he did, in fact, reach out to Paduano's broker (*i.e.*, Kirincic) before calling Lindner, implying that Israel did make an attempt to gauge her interest in a cross-trade with Lee. However, during the hearing Israel testified that he called Kirincic first "to see if [KILN] would be willing to buy the stock." He could not recall specifically whether he considered crossing Lee's order with Paduano's at the time, testifying that he "couldn't tell you exactly" what was going through his mind then. We find that the record does not, therefore, support Israel's contention that he made a reasonable effort to seek Paduano's interest in buying any portion of Lee's shares.

(continued...)

IV.

Applicants contend that FINRA's findings are flawed because of two procedural defects related to (a) Applicants' efforts to use local New York state court procedures to subpoena witnesses, and (b) FINRA's alleged failure to provide "'backup data' in connection with a number of [the Department of] Enforcement's summary exhibits." We discuss each in turn.

A. Subpoenas

Applicants argue that they were deprived of a fair hearing when the FINRA Hearing Officer "abused her discretion" by denying them the opportunity to issue subpoenas for the testimony of KILN market makers, which, they contend, "would have been crucial." Because FINRA rules do not provide for the use of subpoenas, Applicants sought to invoke Section 2302(a) of New York's Civil Practice Law and Rules ("C.P.L.R.") to issue subpoenas for certain information and witnesses.[101] C.P.L.R. Section 2302(a) allows subpoenas "to be issued without a court order by . . . an attorney of record for a party to . . . an administrative proceeding or an arbitration . . . in relation to which proof may be taken or the attendance of a person as a

100 (...continued)
Applicants also argued in their appellate brief to the NAC that the purchase of Lee's shares was a negotiated block transaction and that, therefore, "[t]here can be no argument that the best execution rule does not apply to block transactions." However, as the NAC pointed out, "nothing in the record supports [Applicants'] argument that the transaction (including the purchase price) was negotiated." Indeed, Lee's instructions were simply to liquidate his holdings, and he was not informed of the price he was given for his shares until he received his account statement weeks later. Israel's and Kirlin's duty to provide best execution to Lee attached when they received his order, regardless of the fact that they ultimately (and unilaterally) determined to execute the order as a single block transaction.

101 *But see* FINRA Rules 8210, 9252 (permitting respondents in disciplinary proceedings to request that Enforcement compel the production of documents or testimony to persons subject to FINRA's jurisdiction). The Hearing Officer's order directed Applicants' attention to these provisions as an alternative to the issuance of subpoenas. Applicants eventually availed themselves of this procedure and were granted access to Byrne (and certain of his telephone records) as a witness at the hearing; however, the Hearing Officer denied Applicants' other requests for data and testimony because she found that Applicants did not make good faith efforts to obtain the information elsewhere and/or the information was not relevant. For example, Applicants requested that NASD itself provide, or compel Nasdaq to provide, "trading data for block trades in all Nasdaq securities with average daily trading volume of 25,000 shares or less," but did not attempt to contact vendors such as FACTSET or Thompson to request such information even though Nasdaq had suggested that approach. Applicants do not challenge the Hearing Officer's denial of these other requests, which appear from the record to be justified.

witness may be required."[102] In prohibiting Applicants from issuing subpoenas under this law, the Hearing Officer concluded that C.P.L.R. Section 2302(a) did not apply because Applicants' disciplinary hearing was not an "administrative proceeding" for purposes of the New York rule. The NAC affirmed the Hearing Officer's reasoning and rejected Applicants' objection, as do we.

As we recently explained in *Andrew P. Gonchar*,[103] the New York Supreme Court has determined that C.P.L.R. Section 2302 does not apply to disciplinary proceedings brought by FINRA.[104] We noted that the court's ruling was "consistent with prior New York precedent, which similarly held that NASD disciplinary proceedings are not administrative proceedings within the meaning of C.P.L.R. § 2302 and thus not subject to the New York rule."[105]

Applicants cite *Crimmins v. American Stock Exchange, Inc.*[106] as an example of "at least one court [that] has found that the statute allows for attorneys to issue subpoenas in securities disciplinary proceedings." However, as we have previously noted, *Crimmins* is inapposite. Although the court in *Crimmins* "theorized that C.P.L.R. § 2302 may empower parties to subpoena witnesses in administrative proceedings," the case did not involve FINRA or its rules, did not allow the parties to obtain subpoenas, and addressed the applicability of the statute only in dicta.[107]

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[102] N.Y. C.P.L.R. § 2302 (McKinney 2005).

[103] Exchange Act Rel. No. 60506 (Aug. 14, 2009), 96 SEC Docket 19852, 19870, *appeal filed*, No. 09-4215 (2d Cir. Oct. 8, 2009).

[104] *Gonchar v. NASD*, Index No. 101445-2006, slip op. at 7 (N.Y. Sup. Ct. Feb. 7, 2006) ("Contrary to petitioners' contention, CPLR 2302 does not apply to the Disciplinary Proceeding herein brought by the NASD." (citation omitted)), *dismissed as moot*, 829 N.Y.S. 2d 900 (N.Y. App. Div. Feb. 27, 2007).

[105] *Gonchar*, 96 SEC Docket at 19870 (citing *Application of NASD Regulation, Inc., Dep't of Enforcement v. Rosato*, Index No. 119971-1998, at 2 (N.Y. Sup. Ct. Nov. 5, 1998)).

[106] 368 F. Supp. 270, 277 (S.D.N.Y. 1973).

[107] *Crimmins*, 368 F. Supp. at 277 (noting that C.P.L.R. Section 2302 "seems" to empower both administrative panels and attorneys of record with the ability to issue subpoenas without a court order, but concluding that applicant was not prejudiced by refusal of the American Stock Exchange to subpoena certain witnesses).

Applicants also argue that *NASD v. SEC,* 431 F.3d 803 (D.C. Cir. 2005), stands for the proposition that FINRA, "in carrying out the disciplinary authority granted to it by the SEC[,] acts as an administrative agency" and that, therefore, "[t]here is no question that FINRA (continued...)

Moreover, "an applicant's inability to subpoena witnesses is not grounds for overturning a disciplinary action unless the applicant can show prejudice."[108] Here, Applicants contend without elaboration that testimony from market makers would have "provide[d] insight as to how quotations for KILN were established" and would have "countered any evidence put forth by Enforcement as to how KILN traded and the depth of the market for KILN." However, Applicants themselves testified repeatedly and consistently that KILN was a thinly-traded stock with an average daily volume of less than 10,000 shares that enjoyed negligible interest from institutional investors and non-Kirlin customers. The record also established that trading by Kirincic in March and April accounted for more than 90% of the volume in KILN. Market maker testimony is therefore unlikely to have added to the description of the market activity in KILN already provided by Applicants. Moreover, Applicants do not explain how market maker testimony would be meaningful in determining whether Kirincic's economically irrational

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107 (...continued)
disciplinary proceedings constitute an 'administrative proceeding' for purpose[s] of CPLR § 2302(a)." Applicants misapprehend the import of that case, which simply confirmed that NASD (and now, FINRA) cannot appeal adjudicatory decisions of the Commission because "the authority [NASD] exercises ultimately belongs to the SEC, and the legal views of the self-regulatory organization must yield to the Commission's view of the law." *Id.* at 806. Nothing in *NASD* compels the conclusion that the disciplinary process of FINRA, which has consistently been deemed a "private actor, not a state actor," *D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc.*, 279 F.3d 155, 162 (2d Cir. 2002), is equivalent to an "administrative process" as defined by C.L.P.R. Section 2302(a).

Cf. Administrative Procedure Act, 5 U.S.C. § 551(a) (defining "agency" as "each authority of the Government of the United States" with certain enumerated exceptions, and defining "agency process" as adjudications, rulemakings, and licensing processes of those government agencies); New York State Administrative Procedure Act, Art. I, § 100 (stating that a reason for the enactment of the law was to make more consistent "the administrative rule making, adjudicatory and licensing processes among the agencies of state government" and defining "agency" as "any department, board, bureau, commission, division, office, council, committee or officer of the state," with certain enumerated exceptions).

108 *Gonchar*, 96 SEC Docket at 19871 & n.49 (citing *Crimmins*, 368 F. Supp. at 277 (rejecting plaintiff's attempt to vacate disciplinary action on grounds that plaintiff was not prejudiced by lack of subpoenas); *Thomas E. Warren, III*, 51 S.E.C. 1015, 1020 n.22 (1994) (dismissing allegation that applicant was disadvantaged by inability to subpoena witnesses), *aff'd*, 69 F.3d 549 (10th Cir. 1995); *Gateway Stock & Bond, Inc.*, 43 S.E.C. 191, 195 (1966) (refusing to disturb NASD disciplinary sanctions where lack of subpoena did not cause prejudice)). *See also Foxy Lady, Inc. v. City of Atlanta, Ga.*, 347 F.3d 1232, 1237 (11th Cir. 2003) ("[N]o absolute or independent right to subpoena witnesses exists during administrative proceedings, and [we] now hold expressly that procedural due process also does not require an absolute or independent right to subpoena witnesses in administrative hearings.").

method of placing trades in his sister's account – which often involved entering orders with limit prices far in excess of the inside bid prices set by market makers and then successively raising his limit price – was manipulative. We therefore find that Applicants have not demonstrated that they suffered any prejudice to their case because of their inability to subpoena market maker testimony, and we sustain FINRA's finding that "the Hearing Officer properly refused to permit [them] to use subpoenas."

B. Access to "backup data"

Applicants contend that "Enforcement obviously had access to a tremendous amount of market/trade data, which [Applicants] did not, and Enforcement manipulated the data in a light most favorable to Enforcement's case." Applicants represent that they "had requested access to the same data so that they could perform their own analyses and perhaps demonstrate how Enforcement was wrong," but claim FINRA failed to provide that data. However, the record demonstrates that Applicants were given the data FINRA used to create its hearing exhibits.

Applicants do not now specify what data they claim to lack or even which of Enforcement's exhibits they find to be incorrect, unsubstantiated, or otherwise objectionable. In this regard, we also find it significant that Applicants' expert represented in his report that, in forming his expert opinion that Kirincic did not manipulate the market for KILN, he reviewed electronic market data produced by FINRA, draft market analyses produced by FINRA, and "various charts of the market data created by [Applicants' own] chartists," and made no mention of having insufficient information to form that opinion. Moreover, in making our findings of liability regarding Applicants' manipulation of KILN, we have based our findings in significant part upon exhibits created and submitted by Applicants themselves.[109] Because Applicants have failed to establish what information they were denied and how that denial prejudiced their case, we reject Applicants' argument that the proceedings against them were procedurally flawed.[110]

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[109] For example, we drew upon trade activity reports and account statements for Paduano's and Kirincic's parents' accounts at Kirlin (Applicants' Exhibits 173(6), 230(3), 245); reports showing the intraday movement of KILN's bid and ask prices (Applicants' Exhibits 161(29) and 215(25)); line graphs and tables of the price movement in KILN (Applicants' Exhibits 114, 115, 118, 213(4)); a lengthy and detailed spreadsheet showing Kirincic's orders and executions on BRUT along with the contemporaneous bid and ask prices for KILN for each day during the Trading Period (Applicants' Exhibit 208(20)); and various public filings and correspondence that relate to the KILN's delisting from Nasdaq (Applicants' Exhibits 100, 125, 188(18)).

[110] *See Gateway Stock & Bond,* 43 S.E.C. at 195 & n.9 (rejecting applicants' argument that they were denied due process in the conduct of the proceedings against them because "[a]pplicants have not shown that they were prejudiced by the manner in which evidence was presented . . . or that any material evidence was not produced").

V.

Because we affirm FINRA's findings of violation against Applicants and reject Applicants' procedural arguments, we turn now to a review of the sanctions FINRA imposed. Exchange Act Section 19(e)(2) directs us to sustain the sanctions imposed by FINRA 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.[111] Applicants make no specific arguments as to the propriety of the sanctions FINRA imposed, but they assert generally that "the sanctions imposed by the Hearing Panel and confirmed by the NAC exceed the sanctions called for under the circumstances" and "should be reduced to be commensurate with the FINRA guidelines."

A. Market manipulation: Kirincic, Israel, and Kirlin

For manipulating the market in KILN stock, FINRA barred Kirincic and Israel in all capacities and expelled Kirlin from FINRA membership. In deciding upon these sanctions, FINRA noted that its Sanction Guidelines do not specifically address market manipulation as a distinct violation, but do provide guidance for sanctioning general misrepresentations or omissions of material fact: this guideline recommends a suspension of up to two years for intentional or reckless misconduct, or a bar (or expulsion, for firms) in egregious cases.[112] FINRA also "look[ed] to Commission precedent regarding the gravity of the violation and to the general considerations in determining sanctions, as set forth in the Guidelines."

We find that FINRA appropriately considered the relevant guidelines as well as aggravating and mitigating circumstances in deciding to bar Kirincic and expel Kirlin. As FINRA observed, "'there are few, if any, more serious offenses than manipulation. Such misconduct is a fraud perpetrated not merely on particular customers but on the entire market.'"[113] FINRA properly concluded that the manipulative conduct here was egregious, finding that the scheme was "intentional, extensive, and involved more than 115 trades spanning a five-week period." FINRA further took into account the fact that Kirincic and Kirlin have disciplinary

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[111] 15 U.S.C. § 78s(e)(2). Applicants do not allege, and the record does not show, that FINRA's action imposed an undue burden on competition.

[112] *See Charles C. Fawcett, IV*, Exchange Act Rel. No. 56770 (Nov. 8, 2007), 91 SEC Docket 3147, 3156 n.24 ("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).").

[113] *Quoting John Montelbano*, 56 S.E.C. 76, 105 (Jan. 22, 2003); *see also Pagel*, 48 S.E.C. at 231-32 ("Manipulation strikes at the heart of the pricing process on which all investors rely. It attacks the very foundation and integrity of the free market system. Thus it runs counter to the basic objectives of the securities laws.").

histories that bear on this case, pointing out that they entered into four Letters of Acceptance, Waiver, and Consent with FINRA since 2001, including one in 2004 based on allegations that, among other things, they both "failed to disclose material facts and made material misrepresentations."[114] It also took into consideration that the manipulative scheme inured to the benefit of KILN, of which Kirincic owned twenty percent, and to the benefit of Kirincic's relatives, who sold KILN stock at inflated prices during the Trading Period. The bar FINRA imposed against Kirincic and the expulsion of Kirlin are in accordance with FINRA's guidelines under the circumstances of this case and will protect the market and investors from the risk of future violations that they present while also deterring others from engaging in the same serious misconduct. We therefore find that these sanctions are neither excessive nor oppressive.[115]

However, we find that the bar against Israel is excessive. As explained above, Israel's involvement in the manipulative scheme was reckless, but the record does not demonstrate that he acted with the same degree of intent as that of Kirincic, who orchestrated the scheme and exercised all price and time discretion over the manipulative trades. Israel was also physically absent from Kirlin while on vacation for one week in April, which included the day (April 3) when Kirincic placed a 2,000-share purchase order with Herzog that was responsible for supporting KILN's price throughout the latter half of the Trading Period. Moreover, unlike Kirincic, Israel does not appear to have had any direct or significant financial stake in the scheme: he testified that his only KILN share holdings were in the form of a few thousand options that had not yet vested.[116] These factors serve to mitigate the sanctions against Israel. We conclude, therefore, that an associational bar with a right to reapply after five years is more commensurate with the circumstances of Israel's conduct and is sufficient to encourage him, and others in the industry confronted with similar situations, to conduct themselves with more attention to compliance with the securities laws.

B. Best execution: Israel and Kirlin

For failing to provide Lee with best execution on his trade, FINRA ordered Israel and Kirlin to pay restitution in the amount of $26,163, plus interest. As FINRA noted in its decision, "[r]estitution is 'used to restore the status quo ante where a victim otherwise would unjustly suffer loss' [and] 'seeks to restore a respondent's victim to the position he was in prior to the

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[114] Kirlin agreed, among other things, to pay a fine of $155,800 and restitution of over $1 million; Kirincic agreed to a $25,000 fine and a thirty-day suspension from associating with an NASD member in a general securities principal capacity.

[115] In light of the bar against Kirincic for his fraudulent manipulation of the market for KILN shares, we have determined to set aside the additional bar that FINRA imposed upon Kirincic for signing his parents' names to several transactional documents.

[116] In his post-hearing brief filed with the FINRA Hearing Panel, Israel represented that his salary was approximately $75,000 annually.

transaction by returning to the victim the amount by which the victim was deprived.'"[117] FINRA calculated the amount owed to Lee by adding together (a) $7,410, representing the difference in price on 24,700 shares at $1.10 per share (versus $.80 per share) that Lee would have received if his order had been crossed with Paduano's outstanding buy order; and (b) $18,753, representing the difference in price on the remaining 89,300 shares of Lee's order at $1.01 per share (versus $.80 per share), which FINRA deemed "the lowest price that the market would have reached that day *given the market manipulation.*"[118] FINRA therefore based its restitution award on a comparison of the price Lee received to the price at which KILN was trading in a fraudulently manipulated market. As noted, KILN's closing price averaged $.92 in January 2002, $.86 in February 2002, and had dropped to $.64 on March 15, 2002, the trading day before Kirincic began placing orders in his sister's account (roughly a month before the Lee transaction). Given the size of Lee's sale order, the thinly-traded nature of KILN, and the low prices at which KILN would have traded without being artificially inflated by Kirincic's scheme, we cannot conclude that $.80 per share was an objectively unfair price such that Lee can be said to have suffered a "loss" that must be remedied.[119] To reimburse a customer for a share price difference that would likely never have existed but for fraud would not serve the purposes of restitution.[120] Under the circumstances, therefore, we do not believe restitution is appropriate here.

In sum, we sustain FINRA's findings of violation but set aside and reduce certain of the sanctions imposed, as described herein.[121] An appropriate order will issue.

By the Commission (Commissioners CASEY, WALTER, AGUILAR, and PAREDES; Chairman SCHAPIRO not participating.)

Elizabeth M. Murphy
Secretary

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

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[117] Citations omitted.

[118] Emphasis added.

[119] As discussed, however, we find that although Lee happened to have received a price consistent with, and likely above, the price for KILN shares in an unmanipulated market, nevertheless, the way in which that price was determined did not comply with best execution requirements. *See supra* note 100 and accompanying text.

[120] *See Hibbard, Brown & Co., Inc.*, 52 S.E.C. 170, 183 n.65 (1995) (noting the distinction between the remedial purposes of fines, which are "normally imposed as a deterrent against future misconduct," and restitution, which "requires a wrongdoer to restore his victim to the status quo ante").

[121] We have considered all of the arguments of the parties. We reject or sustain 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. 61135 / December 10, 2009

Admin. Proc. File No. 3-13422

In the Matter of the Application of

KIRLIN SECURITIES, INC.
ANTHONY KIRINCIC
and
ANDREW ISRAEL

c/o Isaac M. Zucker
Law Offices of Isaac M. Zucker, PLLC
600 Old Country Road, Suite 321
Garden City, NY 11530

For Review of Disciplinary Action Taken by
FINRA

ORDER SUSTAINING IN PART DISCIPLINARY ACTION

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

ORDERED that the findings of violation by FINRA against Kirlin Securities, Inc., Anthony Kirincic, and Andrew Israel be, and they hereby are, sustained; and it is further

ORDERED that the bar imposed by FINRA on Anthony Kirincic for fraudulent manipulation of the market in violation of Exchange Act Section 10(b), Exchange Act Rule 10b-5, and NASD Conduct Rules 2120 and 2110 be, and it hereby is, sustained; and it is further

ORDERED that the bar imposed by FINRA on Anthony Kirincic in connection with improperly signing customer names to transactional documents in violation of NASD Conduct Rule 2110 be, and it hereby is, set aside; and it is further

ORDERED that the expulsion from FINRA membership imposed on Kirlin Securities, Inc. for fraudulent manipulation of the market in violation of Exchange Act Section 10(b), Exchange Act Rule 10b-5, and NASD Conduct Rules 2120 and 2110 be, and it hereby is, sustained; and it is further

ORDERED that the bar imposed on Andrew Israel for fraudulent manipulation of the market in violation of Exchange Act Section 10(b), Exchange Act Rule 10b-5, and NASD Conduct Rules 2120 and 2110 be, and it hereby is, set aside; and it is further

ORDERED that Andrew Israel be barred from associating in any capacity with a FINRA member firm with a right to apply for re-entry after five years from February 25, 2009; and it is further

ORDERED that the restitution order, in the amount of $26,163 plus interest, imposed by FINRA jointly and severally on Andrew Israel and Kirlin Securities, Inc. for failing to provide best execution in violation of NASD Conduct Rule 2110 be, and it hereby is, set aside.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter and Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61142 / December 10, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-11987

In the Matter of **CANADIAN IMPERIAL HOLDINGS, INC. AND CIBC WORLD MARKETS CORP.** **Respondents.**	**NOTICE OF PROPOSED PLAN OF DISTRIBUTION AND OPPORTUNITY FOR COMMENT**

Notice is hereby given, pursuant to Rule 1103 of the Securities and Exchange Commission's ("Commission") Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. §201.1103, that the Division of Enforcement has filed with the Commission the proposed plan for the distribution of the Fair Fund in this matter ("Distribution Plan"). On July 20, 2005, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order") against Canadian Imperial Holdings, Inc. and CIBC World Markets Corp. (together, "Respondents") in this matter. *In the Matter of Canadian Imperial Holdings, Inc. and CIBC World Markets Corp.* Administrative Proceeding File No. 3-11987, Securities Act Release No. 8592 (July 20, 2005). In the Order, the Commission authorized the establishment of a Fair Fund, comprised of $125,000,000 in disgorgement, prejudgment interest and penalties paid by

Respondents, for distribution to mutual funds affected by certain market timing activity. The Order provided that the Fair Fund was to be distributed pursuant to a distribution plan developed by an Independent Distribution Consultant.

OPPORTUNITY FOR COMMENT

Pursuant to this Notice, all interested parties are advised that they may obtain a copy of the Distribution Plan from the Commission's public website, http://www.sec.gov/litigation/fairfundlist.htm#cibc, or by submitting a written request to William Finkel, Senior Counsel, United States Securities and Exchange Commission, 3 World Financial Center, New York, NY 10281. Further, all persons desiring to comment on the Distribution Plan may submit their comments, in writing, no later than 30 days from the date of this Notice:

1. to the Office of the Secretary, United States Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090;
2. by using the Commission's Internet comment form, http://www.sec.gov/litigation/admin.shtml; or
3. by sending an e-mail to rule-comments@sec.gov.

Comments submitted by email or via the Commission's website should include "Administrative File Number 3-11987" in the subject line. Comments received will be available to the public. Persons should only submit information that they wish to make publicly available.

DISTRIBUTION PLAN

The Fair Fund is comprised of disgorgement and prejudgment interest of $100,000,000 and civil penalty of $25,000,000.00 paid by Respondents, plus accumulated interest and amounts that may be deposited into the Fair Fund from respondents in related administrative proceedings, less any federal, state, or local taxes on the interest. The Distribution Plan provides for distribution of the Fair Fund to mutual funds affected by the market timing between 1999 and January 2003 as described in the Order. If the Distribution Plan is approved, the affected mutual funds will receive proportionate shares of the Fair Fund as calculated by the Independent Distribution Consultant. The shares will be calculated from information provided by Respondents. Affected mutual funds will not need to go through a claims process.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Chairman Schapiro not participating

SECURITIES AND EXCHANGE COMMISSION

[Release No. IA-2959; File No. S7-29-09]

Approval of Investment Adviser Registration Depository Filing Fees

AGENCY: Securities and Exchange Commission.

ACTION: Order; request for comment.

SUMMARY: The Securities and Exchange Commission ("Commission" or "SEC") is, for one year, reducing Investment Adviser Registration Depository annual and initial filing fees that will be charged beginning January 1, 2010 through December 31, 2010.

DATES: Effective Date: The order will become effective on January 1, 2010.

Comment Due Date: Comments should be received on or before [insert date 45 days after publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-29-09 on the subject line.

Paper Comments:

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

All submissions should refer to File Number S7-29-09. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/other.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 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: Keith Kanyan, IARD System Manager, at 202-551-6737, or Iarules@sec.gov, Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION:

Section 204(b) of the Investment Advisers Act of 1940 ("Advisers Act") authorizes the Commission to require investment advisers to file applications and other documents through an entity designated by the Commission, and to pay reasonable costs associated with such filings.[1] In 2000, the Commission designated the Financial Industry Regulatory Authority Regulation, Inc. ("FINRA") as the operator of the Investment Adviser Registration Depository ("IARD") system. At the same time, the Commission approved, as reasonable, filing fees.[2] The Commission later required advisers registered

1 15 U.S.C. 80b-4(b).

2 Designation of NASD Regulation, Inc., to Establish and Maintain the Investment Adviser Registration Depository; Approval of IARD Fees, Investment Advisers Act Release No. 1888 (July 28, 2000) [65 FR 47807 (Aug. 3, 2000)]. FINRA was formerly known as NASD.

or registering with the SEC to file Form ADV through the IARD.[3] Over 11,000 advisers now use the IARD to register with the SEC and make state notice filings electronically through the Internet.

Commission staff, representatives of the North American Securities Administrators Association, Inc. ("NASAA"),[4] and representatives of FINRA periodically hold discussions on IARD system finances. In the early years of operations, SEC-associated IARD revenues exceeded projections while SEC-associated IARD expenses were lower than estimated, resulting in a surplus. In 2005, FINRA wrote a letter to SEC staff recommending a waiver of annual fees for a one-year period.[5] The Commission concluded that this was appropriate and waived annual fees.[6] In 2006, 2008, and 2009 FINRA wrote to the staff again, recommending a two-year, a nine-month, and a five-month waiver, respectively, of all fees to continue to reduce the surplus.[7] The Commission agreed and issued orders waiving all IARD fees.[8] As a result of these four

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3 Electronic Filing by Investment Advisers; Amendments to Form ADV, Investment Advisers Act Release No. 1897 (Sept. 12, 2000) [65 FR 57438 (Sept. 22, 2000)].

4 The IARD system is used by both advisers registering or registered with the SEC and advisers registered or registering with one or more state securities authorities. NASAA represents the state securities administrators in setting IARD filing fees for state-registered advisers.

5 NASD letter dated September 9, 2005, available at http://www.sec.gov/rules/other/nasdlet090905.pdf.

6 Approval of Investment Adviser Registration Depository Filing Fees, Investment Advisers Act Release No. 2439 (Oct. 7, 2005) [70 FR 59789 (Oct. 13, 2005)].

7 NASD letter dated October 13, 2006 and FINRA letters dated October 10, 2008 and July 8, 2009 available at http://www.sec.gov/rules/other/2006/nasdletter101306-iardfee.pdf, http://www.sec.gov/rules/other/2008/finraletter101008-iardfees.pdf, and http://www.sec.gov/rules/other/2009/finraletter070809-iardfees.pdf, respectively.

8 Approval of Investment Adviser Registration Depository Filing Fees, Investment Advisers Act Release No. 2564 (Oct. 26, 2006), Investment Advisers Act Release No. 2806 (Oct. 30, 2008) [73 FR 65900 (Nov. 5. 2008)], and Investment Advisers Act Release No. 2909 (July 31, 2009) [74 FR 39352 (Aug. 6, 2009)]

waivers, which waived a total of $18 million in filing fees, the surplus was reduced from $9 million in 2005 to approximately $3 million today.

FINRA has again written to Commission staff, recommending reduced annual and initial IARD filing fees for a period of one year commencing on January 1, 2010. The recommended annual filing fees due beginning January 1, 2010 are $40 for advisers with assets under management under $25 million; $150 for advisers with assets under management from $25 million to $100 million; and $200 for advisers with assets under management over $100 million. The recommended initial IARD filing fees due beginning January 1, 2010 are $40 for advisers with assets under management under $25 million; $150 for advisers with assets under management from $25 million to $100 million; and $200 for advisers with assets under management over $100 million. Based on projections of expected revenues and expenses, the Commission believes these reduced fee levels would be reasonable for this year, as the Commission projects that they will provide adequate funding to cover IARD system expenditures.[9] This action is expected to reduce aggregate filing fees that SEC-registered advisers would incur by approximately $2 million annually compared to the filing fees that would be collected based on the fee levels established in 2000. The revised filing fees will apply to all annual updating amendments filed by SEC-registered advisers beginning January 1, 2010 and to all initial applications for registration filed by advisers applying for SEC registration beginning January 1, 2010. The Commission will reassess the fee levels

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[9] The previous initial filing fees were $150 for advisers with assets under management under $25 million; $800 for advisers with assets under management from $25 million to $100 million; and $1,100 for advisers with assets under management over $100 million. The previous annual filing fees were $100 for advisers with assets under management under $25 million; $400 for advisers with assets under management from $25 million to $100 million; and $550 for advisers with assets under management over $100 million.

prior to the end of the one-year period and welcomes any comments on the fee levels, including whether the reduced fee levels in this Order would be appropriate as permanent fee levels.

IT IS THEREFORE ORDERED, pursuant to Sections 204(b) and 206(A) of the Investment Advisers Act of 1940, that:

For annual updating amendments to Form ADV filed from January 1, 2010 through December 31, 2010, the filing fee due from SEC-registered advisers is $40 for advisers with assets under management under $25 million; $150 for advisers with assets under management from $25 million to $100 million; and $200 for advisers with assets under management over $100 million.

For initial applications to register as an investment adviser with the SEC filed from January 1, 2010 through December 31, 2010, the filing fee due from SEC-registered advisers is $40 for advisers with assets under management under $25 million; $150 for advisers with assets under management from $25 million to $100 million; and $200 for advisers with assets under management over $100 million.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: December 10, 2009

Commissioner Casey not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61146 / December 10, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3075 / December 10, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13708

In the Matter of **Kenneth Mueller, CPA** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Kenneth Mueller, CPA, ("Respondent" or "Mueller") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

[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.

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 paragraph three of Section III below, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Kenneth Mueller, age 56, was the Chief Financial Officer ("CFO") of SafeNet, Inc., from June 2004 until he resigned on April 6, 2006. Since July 30, 1984, Mueller has been a Certified Public Accountant in the state of Illinois.

2. SafeNet, Inc. ("SafeNet" or the "Company") is a Delaware corporation, with its headquarters in Belcamp, Maryland. SafeNet produces information security software products. During the relevant period, the Company's common stock was registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") and listed on the NASDAQ Global Market under the symbol "SFNT." In April 2007, SafeNet was taken private by Vector Capital Corporation.

3. On November 12, 2009, the Commission filed a complaint against Mueller in SEC v. SafeNet, Inc., et. al., Civil Case No. 09-2117 (D.D.C). On December 2, 2009, the court entered a final judgment permanently enjoining Mueller, by consent, from future violations of Section 17(a) of the Securities Act of 1933, Sections 10(b), 13(b)(5), 14(a), and 16(a) of the Exchange Act, and Rules 10b-5, 13a-14, 13b2-1, 13b2-2, 14a-9, 16a-3, and Regulation G 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, 13a-11, and 13a-13 thereunder. Mueller was also prohibited, for a period of five years, from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act, and was ordered to pay disgorgement of $37,000, plus prejudgment interest of $13,561, and a civil penalty of $75,000.

4. The Commission's complaint alleged that, during the period from the fourth quarter of 2000 through May 2006, SafeNet, through the actions of its former senior officers, engaged in a scheme to backdate option grants to senior executives and other employees in order to take advantage of low points in the Company's stock price, without recording the requisite compensation expense for these option grants. The complaint alleged that, in late 2004, Mueller learned of SafeNet's backdating practice. According to the complaint, after learning of the practice, Mueller continued the backdating scheme by, among other actions, approving a

highly favorable historical date, coinciding with a low closing stock price, to use as the grant date for option grants to himself and other SafeNet employees. In addition, the complaint alleged that, from the third quarter of 2004 through the second quarter of 2005, SafeNet, through the actions of Mueller, another former officer, and three former accountants, engaged in a scheme to assist SafeNet in meeting or exceeding quarterly earnings per share targets through the use of improper accounting adjustments. According to the complaint, as a result of each of these schemes, SafeNet's periodic reports, registration statements, and press releases contained materially misstated financial results and materially false and misleading information concerning SafeNet's financial condition. The complaint alleged that, during Mueller's involvement in the two schemes, as SafeNet's CFO, he prepared, reviewed and/or signed SafeNet's materially false and misleading securities filings and press releases.

IV.

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

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

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

B. After five years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must further 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 Registration 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.

Elizabeth M. Murphy
Elizabeth M. Murphy
Secretary

Commissioner Casey not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61149 / December 10, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3078 / December 10, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13711

In the Matter of Gregory Pasko, CPA Respondent.	ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Gregory Pasko, CPA, ("Respondent" or "Pasko") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of

[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.

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 paragraph three of Section III below, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Gregory Pasko, age 43, was the Director of External Reporting of SafeNet, Inc., from January 2005 through May 2005. Since 1995, Pasko has been licensed as a Certified Public Accountant in the state of Maryland.

2. SafeNet, Inc. ("SafeNet" or the "Company") is a Delaware corporation, with its headquarters in Belcamp, Maryland. SafeNet produces information security software products. During the relevant period, the Company's common stock was registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") and listed on the NASDAQ Global Market under the symbol "SFNT." In April 2007, SafeNet was taken private by Vector Capital Corporation.

3. On November 12, 2009, the Commission filed a complaint against Pasko in SEC v. SafeNet, Inc., et. al., Civil Case No. 09-2117 (D.D.C). On December 2, 2009, the court entered a final judgment permanently enjoining Pasko, by consent, from future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, and Rules 13b2-1 and 13b2-2 under the Exchange Act, 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, 13a-11, and 13a-13 thereunder. The final judgment ordered Pasko to pay a civil penalty of $15,000.

4. The Commission's complaint alleged that, from the third quarter of 2004 through the second quarter of 2005, SafeNet, through the conduct of its former employees, engaged in a scheme to assist SafeNet in meeting or exceeding quarterly earnings per share targets through the use of improper accounting adjustments. The complaint alleged that Pasko and others made, or caused others to make, certain improper accounting adjustments in SafeNet's books and records. The complaint also alleged that, as a result of these inappropriate adjustments, SafeNet's periodic reports, registration statements, and press releases contained materially misstated financial results and materially false and misleading information concerning SafeNet's financial condition.

IV.

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

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

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

B. After one year from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or 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 further 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.

Elizabeth M. Murphy
Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61147 / December 10, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3076 / December 10, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13709

In the Matter of **Clinton Ronald Greenman, CPA** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Clinton Ronald Greenman, CPA, ("Respondent" or "Greenman") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

[1] Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in paragraph three of Section III below, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Clinton Ronald Greenman, age 41, was SafeNet's Corporate Controller from December 2002 through December 2004. From December 2004 through May 26, 2005, Greenman was the Director for the Americas Regional Operating Center at SafeNet. Since May 1996, Greenman has been licensed as a Certified Public Accountant in the State of New York.

2. SafeNet, Inc. ("SafeNet" or the "Company") is a Delaware corporation, with its headquarters in Belcamp, Maryland. SafeNet produces information security software products. During the relevant period, the Company's common stock was registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"), and listed on the NASDAQ Global Market under the symbol "SFNT." In April 2007, SafeNet was taken private by Vector Capital Corporation.

3. On November 12, 2009, the Commission filed a complaint against Greenman in SEC v. SafeNet, Inc., et. al, Civil Case No. 09-2117 (D.D.C). On December 2, 2009, the court entered a final judgment permanently enjoining Greenman, by consent, from future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, and Rules 13b2-1 and 13b2-2 under the Exchange Act, 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, 13a-11, and 13a-13 thereunder. The final judgment also found Greenman liable to pay disgorgement of $45,000, plus prejudgment interest of $13,960, but waived these payments, except for $15,000, and did not impose a civil penalty based on Greenman's sworn financial statement and supporting materials provided to the Commission.

4. The Commission's complaint alleged that, from the third quarter of 2004 through the second quarter of 2005, SafeNet, through the conduct of its former employees, engaged in a scheme to assist SafeNet in meeting or exceeding quarterly earnings per share targets through the use of improper accounting adjustments. The complaint alleged that Greenman and others made, or caused others to make, certain improper accounting adjustments in

SafeNet's books and records. The complaint also alleged that, as a result of these inappropriate adjustments, SafeNet's periodic reports, registration statements, and press releases contained materially misstated financial results and materially false and misleading information concerning SafeNet's financial condition.

IV.

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

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

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

B. After two 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 further 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.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Casey not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61148 / December 10, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3077 / December 10, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13710

In the Matter of **John Wilroy, CPA** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against John Wilroy, CPA, ("Respondent" or "Wilroy") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

[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.

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 paragraph three of Section III below, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. John Wilroy, age 50, was the Worldwide Controller of SafeNet, Inc., from December 2004 through July 29, 2005. Wilroy was licensed as a Certified Public Accountant in the state of Virginia from April 2003 to August 2009.

2. SafeNet, Inc. ("SafeNet" or the "Company") is a Delaware corporation, with its headquarters in Belcamp, Maryland. SafeNet produces information security software products. During the relevant period, the Company's common stock was registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") and listed on the NASDAQ Global Market under the symbol "SFNT." In April 2007, SafeNet was taken private by Vector Capital Corporation.

3. On November 12, 2009, the Commission filed a complaint against Wilroy in SEC v. SafeNet, Inc., et. al, Civil Case No. 09-2117 (D.D.C). On December 2, 2009, the court entered a final judgment permanently enjoining Wilroy, by consent, from future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, and Rules 13b2-1 and 13b2-2 under the Exchange Act, 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, 13a-11, and 13a-13 thereunder. The final judgment also ordered Wilroy to pay a civil penalty of $25,000.

4. The Commission's complaint alleged that, from the third quarter of 2004 through the second quarter of 2005, SafeNet, through the conduct of its former employees, engaged in a scheme to assist SafeNet in meeting or exceeding quarterly earnings per share targets through the use of improper accounting adjustments. The complaint alleged that Wilroy and others made, or caused others to make, certain improper accounting adjustments in SafeNet's books and records. The complaint also alleged that, as a result of these inappropriate adjustments, SafeNet's periodic reports, registration statements, and press releases contained materially misstated financial results and materially false and misleading information concerning SafeNet's financial condition.

IV.

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

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

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

B. After two 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 further 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.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61152; File No. 10-191)

December 10, 2009

In the Matter of the Application of
C2 Options Exchange, Incorporated
for Registration as a National Securities Exchange

Findings, Opinion, and Order of the Commission

I. Introduction

On January 21, 2009, the Chicago Board Options Exchange, Incorporated ("CBOE") submitted to the Securities and Exchange Commission ("Commission") an Application for Registration as a National Securities Exchange ("Form 1") seeking registration under Section 6 of the Securities Exchange Act of 1934[1] (the "Act") of a second national securities exchange, referred to as C2 Options Exchange, Incorporated ("C2" or the "Exchange"). Notice of the application was published for comment in the Federal Register on March 3, 2009.[2] The

1 15 U.S.C. 78f.

2 See Securities Exchange Act Release No. 59441 (February 24, 2009), 74 FR 9322 ("Notice").

Commission received one comment letter regarding the C2 Form 1.[3] On December 8, 2009, C2 filed Amendment No. 1 to its Form 1.[4]

II. Statutory Standards

Under Sections 6(b) and 19(a) of the Act,[5] the Commission shall by order grant an application for registration as a national securities exchange if it finds that the proposed exchange is so organized and has the capacity to carry out the purposes of the Act and can comply, and can 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.

As discussed in greater detail below, the Commission finds that C2's application for exchange registration meets the requirements of the Act and the rules and regulations thereunder. Further, the Commission finds that the proposed rules of C2 are consistent with Section 6 of the Act in that, among other things, they are designed to: (1) assure fair representation of the

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3 See E-mails from Bryan Rule, dated July 8, 2009 and November 9, 2009. While the July correspondence does not contain any substantive comments on the Form 1 application, the November correspondence asks the Commission not to approve C2's application for registration until CBOE "adequately disciplines its members for their large number of SEC Firm Quote violations…." Mr. Rule asserted that "the new C2 Rules seek to diminish the public's priority in option trading." As discussed further below, the Commission believes that C2's proposed rules, including provisions relating to order execution and priority, are consistent with the Act. In addition, as a self-regulatory organization, C2 – as well as CBOE – is required to comply with the provisions of the Act and the rules and regulations thereunder and enforce compliance with such provisions by its members. See 15 U.S.C. 78s(g).

4 In Amendment No. 1, CBOE modified its application by: revising Exhibits C and D to reflect the removal of entities that do not qualify as affiliates and to provide more current financial information; revising its proposed Bylaws to clarify an inconsistency in Section 3.1; revising Exhibit J to reflect current information; and revising and clarifying the operation of certain proposed rules. The changes proposed in Amendment No. 1 either are not material or are otherwise responsive to the concerns of the Commission.

5 15 U.S.C. 78f(b) and 15 U.S.C. 78s(a), respectively.

Exchange's members in the selection of its directors and administration of its affairs and provide that, among other things, one or more directors shall be representative of investors and not be associated with the exchange, or with a broker or dealer;[6] (2) prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, remove impediments to and perfect the mechanisms of a free and open market and a national market system;[7] (3) not permit unfair discrimination between customers, issuers, or dealers;[8] and (4) protect investors and the public interest.[9] Finally, the Commission finds that the proposed rules of C2 do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.[10]

Overall, the Commission believes that approving C2's application for exchange registration could confer important benefits on the public and market participants. In particular, C2 will provide market participants with an additional venue for executing orders in standardized options and should increase competition between the options exchanges. Consequently, investors should benefit as markets compete on service, price, and execution.

III. Discussion and Commission Findings

A. Background

CBOE, a national securities exchange registered under Section 6 of the Act, has proposed the formation of C2 as a stand-alone options exchange that will operate under a separate

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6 See 15 U.S.C. 78f(b)(3).

7 See 15 U.S.C. 78f(b)(5).

8 See id.

9 See id.

10 See 15 U.S.C. 78f(b)(8).

exchange license and have separate access rules, separate governance, and a separate fee schedule from that of CBOE. Unlike CBOE, which uses a hybrid model market structure, C2 will be an all-electronic marketplace and will not maintain a physical options trading floor. CBOE filed its C2 proposal during a time of increasing consolidation among U.S. registered exchanges in which exchange holding companies have sought to control multiple, separate exchange licenses in order to offer multiple and varied trading venues to appeal to a broad array of market participants.[11] The primary features of the C2 proposal, discussed in more detail in C2's Form 1, are discussed below.

B. Corporate Structure of C2

1. Ownership

C2 will be a wholly-owned subsidiary of its parent company, CBOE. The C2 governing documents explicitly state that CBOE owns 100% of the common stock of C2 and that any sale, transfer, or assignment by CBOE of its ownership stake in C2 will not be permitted without Commission approval pursuant to the rule filing procedures under Section 19 of the Act.[12] CBOE, itself a self-regulatory organization ("SRO"), will therefore own C2, which will be a separate SRO.[13]

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11 See, e.g., Securities Exchange Act Release Nos. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008) (File No. SR-Phlx-2008-31) (approval order concerning changes to the governing documents of the Philadelphia Stock Exchange, Inc. in connection with its acquisition by The NASDAQ OMX Group, Inc.); and 58673 (September 29, 2008), 73 FR 57707 (October 3, 2008) (File Nos. SR-Amex-2008-62 and SR-NYSE-2008-60) (approval order concerning the acquisition of the American Stock Exchange LLC by NYSE Euronext).

12 See Article Fourth of the Certificate of Incorporation of C2 ("C2 Certificate of Incorporation"). See also 15 U.S.C. 78s.

13 The acquisition of the American Stock Exchange LLC ("Amex") by the National Association of Securities Dealers, Inc. ("NASD") in 1998 involved a similar corporate structure. See Securities Exchange Act Release No. 40622 (October 30, 1998), 63 FR

While recent consolidation among U.S. exchanges has involved ownership of multiple exchanges under a single holding company structure, that structure is unavailable to CBOE, which presently is structured as a mutually-held member-owned organization. CBOE has, however, proposed to demutualize, though its C2 proposal precedes its efforts to effectuate its planned demutualization.[14]

The Commission notes that, while C2 will be responsible for complying with the legal obligations that govern an exchange, CBOE, in its capacity as the parent company with a controlling interest in C2, also will be responsible for ensuring that C2 meets its obligations as an SRO. In this respect, CBOE has adopted a rule to reflect and codify CBOE's ultimate responsibility to ensure that C2 meets its statutory obligations as an SRO.[15] Among other things, CBOE's policy with respect to C2 represents that CBOE will ensure that necessary and appropriate resources are available to C2 so that it can meet the evolving demands of operating a regulatory and supervisory compliance program. Further, in discharging this responsibility, CBOE's policy states it will exercise its powers and its managerial influence to ensure that C2 fulfills its self-regulatory obligations by directing C2 to take action necessary to effectuate its

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59819 (November 5, 1998) (File Nos. SR-Amex-98-32; SR-NASD-98-56; and SR-NASD-98-67) (approval order).

14 CBOE's planned demutualization has been noticed for comment but has not yet received member approval. See Securities Exchange Act Release No. 58425 (August 26, 2008), 73 FR 51652 (September 4, 2008) (File No. SR-CBOE-2008-88) ("CBOE Demutualization Notice").

15 See Securities Exchange Act Release Nos. 61140 (December 10, 2009) (File No. SR-CBOE-2009-048) (approval order); and 60307 (July 15, 2009), 74 FR 36289 (July 22, 2009) (File No. SR-CBOE-2009-048) (notice of filing). The policy adopted by CBOE is consistent with the resolution of similar questions in the context of the NASD-Amex combination referenced above. See Securities Exchange Act Release Nos. 40622 (October 30, 1998), 63 FR 59819 (November 5, 1998) (File Nos. SR-Amex-98-32; SR-NASD-98-56; and SR-NASD-98-67) (approval order); and 40443 (September 16, 1998), 63 FR 51108 (September 24, 1998) (File No. SR-NASD-98-67) (notice of filing of NASD's policy with respect to its authority over the Amex).

purposes and functions as a national securities exchange operating pursuant to the Act, and ensuring that C2 has and appropriately allocates such financial, technological, technical, and personnel resources as may be necessary or appropriate to meet its obligations under the Act. Finally, CBOE has committed to refrain from taking any action with respect to C2 that, to the best of its knowledge, would impede, delay, obstruct, or conflict with efforts by C2 to carry out its SRO obligations under the Act, and the rules and regulations thereunder. The Commission believes that CBOE's policy statement specifies the role and responsibility of CBOE in the operation of C2.

The Commission believes that the proposed corporate structure of C2 is consistent with the Act and that C2 will be so organized and have the capacity to be able to carry out the purposes of the Act and to comply and enforce compliance by its members and persons associated with its members with all applicable rules and regulations. C2's proposed ownership by CBOE, coupled with the explicit restriction on any indirect or direct transfer of such control by CBOE, should minimize the potential that any person could interfere with or restrict the ability of C2, CBOE, or the Commission to effectively carry out their respective regulatory oversight responsibilities. Further, the Commission notes that CBOE has undertaken to ensure and maintain the regulatory independence of C2 to enable C2 to operate in a manner that complies with the federal securities laws, including the objectives of Sections 6(b) and 19(g) of the Act.[16]

[16] 15 U.S.C. 78f(b) and 15 U.S.C. 78s(g), respectively.

2. Governance

As part of its Form 1 application, C2 submitted a proposed Certificate of Incorporation and Bylaws. In these documents, among other things, C2 establishes the composition of the Exchange's board of directors and the Exchange's governance committees.[17]

a. The C2 Board of Directors

C2's Board of Directors ("Board") will be the governing body of C2 and will possess all of the powers necessary for the management of the business and affairs of the Exchange and the execution of its responsibilities as an SRO, including regulating the business conduct of Trading Permit Holders ("TPHs"), imposing fees, and adopting and amending rules.[18] C2 has proposed the following Board composition requirements, which are comparable to those the Commission has approved for other SROs:[19]

- The Board will be composed of between 11 and 23 directors (the exact number to be fixed from time to time by the Board);[20]
- One director position will be held by the Chief Executive Officer of C2 ("CEO");
- The number of Non-Industry Directors[21] will equal or exceed the sum of the number of Industry Directors[22] (excluding the CEO from the calculation of Industry Directors for such purpose);

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17 The governance structure of C2 is based primarily upon the governance structure that CBOE has proposed in connection with its demutualization. See CBOE Demutualization Notice, supra note 14, at 73 FR 51654.

18 See C2 Bylaws Article III, Section 3.3.

19 See, e.g., Section 9 of the Limited Liability Company Agreement of The NASDAQ Stock Market LLC ("Nasdaq") and Article III of Nasdaq's By-Laws.

20 See C2 Bylaws Article III, Section 3.1.

21 "Non-Industry Director" is defined as a person who is not an "Industry Director." See id.

- At all times, at least one Non-Industry Director will qualify as a Non-Industry Director other than by operation of the limited exceptions provided for "outside directors" under the definition of "Industry Director" and will have no material business relationship with a broker or dealer, an entity that is affiliated with a broker-dealer, or the Exchange or any of its affiliates;[23]
- The number of Industry Directors will equal or exceed 30% of the Board;[24] and

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22 C2's Bylaws define "Industry Director" as a director that: (i) is a holder of a Trading Permit or otherwise subject to regulation by the Exchange; (ii) is a broker-dealer or an officer, director or employee of a broker-dealer or has been in any such capacity within the prior three years; (iii) is, or was within the prior three years, associated with an entity that is affiliated with a broker-dealer whose revenues account for a material portion of the consolidated revenues of the entities with which the broker-dealer is affiliated; (iv) has a material ownership interest in a broker-dealer and has investments in broker-dealers that account for a material portion of the director's net worth; (v) has a consulting or employment relationship with or has provided professional services to the Exchange or any of its affiliates or has had such a relationship or has provided such services within the prior three years; or (vi) provides, or has provided within the prior three years, professional or consulting services to a broker-dealer, or to an entity with a 50% or greater ownership interest in a broker-dealer whose revenues account for a material portion of the consolidated revenues of the entities with which the broker-dealer is affiliated, and the revenue from all such professional or consulting services accounts for a material portion of either the revenues received by the director or the revenues received by the director's firm or partnership. See id.

23 C2's Bylaws provide a limited exception such that a director would not be deemed to be an "Industry Director" solely because either (A) the person is or was within the prior three years an outside director of a broker-dealer or an outside director of an entity that is affiliated with a broker-dealer, provided that the broker-dealer is not a holder of a Trading Permit or otherwise subject to regulation by the Exchange, or (B) the person is or was within the prior three years associated with an entity that is affiliated with a broker-dealer whose revenues do not account for a material portion of the consolidated revenues of the entities with which the broker-dealer is affiliated, provided that the broker-dealer is not a holder of a Trading Permit or otherwise subject to regulation by the Exchange. At all times, however, at least one Non-Industry Director must qualify as a Non-Industry Director exclusive of the exceptions provided for in the immediately preceding sentence and shall have no material business relationship with a broker or dealer or the Exchange or any of its affiliates. C2's Bylaws specify that the term "outside director" means a director of an entity who is not an employee or officer (or any person occupying a similar status or performing similar functions) of such entity. See id.

24 See id.

- At least 20% of the directors on the Board will be nominated (or otherwise selected by a petition of C2 members) by the Industry-Director Subcommittee of the Nominating and Governance Committee (such directors are referred to collectively as the "Representative Directors").[25]

The initial Board will be divided into two classes. The initial term of the Class I and II directors will end with the annual stockholders meeting to be held by the Exchange in 2009 and 2010, respectively. Thereafter, directors will serve two-year terms ending on the second annual meeting following the meeting at which such directors were elected. Class I directors will initially consist of the Chief Executive Officer, five Non-Industry Directors, and five Industry Directors (two of whom will be Representative Directors). Class II directors will initially consist of seven Non-Industry Directors and five Industry Directors (three of whom will be Representative Directors).[26] All directors will continue in office until their successors are elected or appointed and qualified, except in the event of their earlier death, resignation, or removal.[27]

In addition, within 45 days from the date on which trading commences on C2, the Industry-Director Subcommittee will issue a circular to TPHs identifying a slate of Representative Director nominees.[28] TPHs will thereafter be able to file petitions for the

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25 Only persons who are nominated by the Nominating and Governance Committee as Representative Directors will be eligible for election as Representative Directors and the Nominating and Governance Committee is bound to accept and nominate the Representative Director nominees recommended by the Industry-Director Subcommittee, provided that the Representative Director nominees are not opposed by a petition candidate. If such Representative Director nominees are opposed by a petition candidate then the Nominating and Governance Committee is bound to accept and nominate the Representative Director nominees who receive the most votes pursuant to a run-off election. See C2 Bylaws Article III, Section 3.2.

26 See C2 Bylaws Article III, Section 3.1. and Amendment No. 1.

27 See C2 Bylaws Article III, Section 3.1.

28 See C2 Bylaws Article III, Section 3.2.

nomination of alternate Representative Directors. In the event of a contested election, a run-off election will be held prior to the initial Board election. The Commission notes that because CBOE intends to seed the initial C2 Board with members of CBOE's current board of directors, the Representative Directors on C2's initial Board will have been subject to CBOE member input. As C2's initial permit holders will likely consist substantially of CBOE members,[29] the Commission believes C2's initial Board will provide member representation sufficient to allow the Exchange to commence operations. However, to assure a fair representation of C2 members in the selection of C2's directors and administration of its affairs, C2 has committed to provide C2 members with the prompt opportunity to participate in the selection of Representative Directors, thereby satisfying the compositional requirements for the Board contained in the C2 Bylaws.[30]

The Nominating and Governance Committee will nominate individuals for election as directors of the Board subsequent to the initial Board election process set forth above.[31] The Board will appoint the initial Nominating and Governance Committee and thereafter the Nominating and Governance Committee members will recommend their successors for approval by the Board.

The Industry-Director Subcommittee[32] of the Nominating and Governance Committee will recommend candidates to the Nominating and Governance Committee for each new or

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29 See infra Section III.C.1.a (TPH Access).

30 See C2 Bylaws Article III, Section 3.2.

31 See C2 Bylaws Article III, Section 4.5. The Nominating and Governance Committee will be comprised of at least seven directors and will at all times have a majority of directors that are Non-Industry Directors. See id.

32 The Industry-Director Subcommittee will consist of all of the Industry Directors then serving on the Nominating and Governance Committee. See C2 Bylaws Article III, Section 3.2.

vacant Representative Director position on the Board.[33] Alternate candidates for Representative Director positions may be nominated by TPHs pursuant to a petition process.[34] If no candidates are nominated pursuant to a petition process, then the Nominating and Governance Committee is bound to accept and nominate the Representative Director nominees recommended by the Industry-Director Subcommittee. If a petition process produces additional candidates, then the candidates nominated pursuant to a petition process, together with those nominated by the Industry-Director Subcommittee, will be presented to TPHs in a contested election to determine the final slate of nominees for Representative Director.[35] Candidates who receive the most votes will be nominated as Representative Directors by the Nominating and Governance Committee.[36] CBOE, as the sole shareholder of C2, has committed to elect the candidates nominated by the Nominating and Governance Committee as Representative Directors.[37]

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33 The Industry-Director Subcommittee will provide a mechanism for TPHs to provide input to the Industry-Director Subcommittee with respect to open Representative Director positions. Once selected, the Industry-Director Subcommittee will issue a circular to TPHs identifying the Representative Director nominees selected by the committee. See C2 Bylaws Article III, Section 3.2.

34 See C2 Bylaws Article III, Section 3.2. TPHs may nominate alternative candidates for election to the Representative Director positions to be elected in a given year by submitting a petition signed by individuals representing not less than 10% of the total outstanding Trading Permits at that time. See id.

35 See C2 Bylaws Article III, Section 3.2. Each TPH will have one vote with respect to each Trading Permit held for each Representative Director position to be filled that year; provided, however, that no holder of Trading Permits, either alone or together with its affiliates, may account for more than 20% of the votes cast for a candidate, and any votes cast by a holder of Trading Permits, either alone or together with its affiliates, in excess of this 20% limitation will be disregarded. See id.

36 See id.

37 CBOE, as sole shareholder of C2, has entered into a voting agreement with C2 with respect to the election by CBOE of the Representative Directors whereby CBOE has agreed to vote in favor of those individuals nominated by C2's Nominating and Governance Committee for election as Representative Directors of C2.

The Commission believes that the requirement in the C2 Bylaws that 20% of directors be Representative Directors, together with the process by which such directors are to be nominated and elected, provides for the fair representation of members in the selection of directors and the administration of C2 in a manner consistent with the requirement in Section 6(b)(3) of the Act.[38] As the Commission has previously noted in the context of other exchange governance proposals, this requirement helps to ensure that an exchange's members have a voice in the governing body of the exchange and the corresponding exercise by the exchange of its self-regulatory authority, and that the exchange is administered in a way that is equitable to all who trade on its market or through its facilities.[39]

In addition, the requirement that the number of Non-Industry Directors equal or exceed the number of Industry Directors on the Board is designed to assure the inclusion of a significant non-industry presence in the governance of the Exchange, which the Commission believes is a critical element in an exchange's ability to protect the public interest.[40] Further, the Commission notes that at all times at least one Non-Industry Director will qualify as not an "Industry Director" without using the limited exceptions provided for "outside directors" under the definition of "Industry Director" and will have no material business relationship with a broker or dealer, an entity that is affiliated with a broker-dealer, or the Exchange or any of its affiliates.[41]

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38 15 U.S.C. 78f(b)(3).

39 See, e.g., Securities Exchange Act Release Nos. 53128 (January 13, 2006), 71 FR 3550, 3553 (January 23, 2006) (File No. 10-131) ("Nasdaq Exchange Registration Order"); 53382 (February 27, 2006), 71 FR 11251, 11259 (March 6, 2006) (File No. SR-NYSE-2005-77) ("NYSE/Archipelago Merger Approval Order"); and 58375 (August 18, 2008), 73 FR 49498, 49501 (August 21, 2008) (File No. 10-182) ("BATS Exchange Registration Order").

40 See, e.g., Nasdaq Exchange Registration Order, supra note 39, at 71 FR 3553.

41 See C2 Bylaws Article III, Section 3.1.

In other words, at least one of C2's directors will not have any association with C2, a member of C2, or a broker or dealer, consistent with Section 6(b)(3) of the Act.[42]

The Commission believes that non-industry directors help ensure that no single group of market participants has the ability to unfairly disadvantage other market participants through the exchange governance process. Non-industry directors can provide unique and unbiased perspectives, which should enhance the ability of the Board to address issues in a non-discriminatory fashion and consequently support the integrity of C2's governance.[43] Accordingly, the Commission finds that C2's proposed Board satisfies the requirements in Section 6(b)(3) of the Act,[44] which requires that one or more directors be representative of issuers and investors and not be associated with a member of the exchange, or with a broker or dealer.

b. C2 Exchange Committees

C2 has proposed to establish the following standing committees of the Board: Executive Committee;[45] Audit Committee;[46] Compensation Committee;[47] Regulatory Oversight

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42 15 U.S.C. 78f(b)(3).

43 See, e.g., Nasdaq Exchange Registration Order, supra note 39, at 71 FR 3553; and NYSE/Archipelago Merger Approval Order, supra note 39, at 71 FR 11261.

44 15 U.S.C. 78f(b)(3).

45 See C2 Bylaws, Article IV, Section 4.2. The Executive Committee will include the Chairman of the Board, the Chief Executive Officer (if a director), the Vice Chairman of the Board, the Lead Director, if any, at least one Representative Director and such other number of directors that the Board deems appropriate, provided that in no event will the number of Non-Industry Directors constitute less than the number of Industry Directors serving on the Executive Committee (excluding the Chief Executive Officer from the calculation of Industry Directors for such purpose). Members of the Executive Committee (other than those specified in the immediately preceding sentence) will be recommended by the Nominating and Governance Committee for approval by the Board.

46 See C2 Bylaws, Article IV, Section 4.3. The Audit Committee will consist of at least three directors, all of whom will be Non-Industry Directors and all of whom will be recommended by the Nominating and Governance Committee for approval by the Board.

Committee;[48] and Nominating and Governance Committee.[49] The Board will appoint the initial members of the Nominating and Governance Committee, and thereafter the Nominating and Governance Committee will promptly act to recommend candidates for the other committees of the Board. Members of the standing committees will not be subject to removal except by the Board.[50] The Commission believes that C2's proposed committees, which are similar to the

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The exact number of Audit Committee members will be determined from time to time by the Board. The Chairman of the Audit Committee will be recommended by the Nominating and Governance Committee for approval by the Board.

47 See C2 Bylaws, Article IV, Section 4.4. The Compensation Committee will consist of at least three directors, all of whom will be Non-Industry Directors and all of whom will be recommended by the Nominating and Governance Committee for approval by the Board. The exact number of Compensation Committee members will be determined from time to time by the Board. The Chairman of the Compensation Committee will be recommended by the Nominating and Governance Committee for approval by the Board.

48 See C2 Bylaws, Article IV, Section 4.6. The Regulatory Oversight Committee will consist of at least four directors, all of whom will be Non-Industry Directors and all of whom will be recommended by the Non-Industry Directors on the Nominating and Governance Committee for approval by the Board. The exact number of Regulatory Oversight Committee members will be determined from time to time by the Board. The Chairman of the Regulatory Oversight Committee will be recommended by the Non-Industry Directors of the Nominating and Governance Committee for approval by the Board.

49 See C2 Bylaws, Article IV, Section 4.5. The Nominating and Governance Committee will consist of at least seven directors, including both Industry Directors and Non-Industry Directors, and will at all times have a majority of directors that are Non-Industry Directors. All members of the committee, except for the initial members of the committee (appointed to the committee in accordance with Section 4.1 of the Bylaws), will be recommended by the Nominating and Governance Committee for approval by the Board. The exact number of Nominating and Governance Committee members will be determined from time to time by the Board. The Chairman of the Nominating and Governance Committee will be recommended by the Nominating and Governance Committee for approval by the Board. Subject to Section 3.2 and Section 3.5 of the Bylaws, the Nominating and Governance Committee will have the authority to nominate individuals for election as directors of the Corporation.

50 See, e.g., C2 Bylaws, Article IV, Section 4.5.

committees maintained by other exchanges,[51] are designed to enable C2 to carry out its responsibilities under the Act and are consistent with the Act.

C. Regulation of C2

As a prerequisite for the Commission's approval of an exchange's application for registration, an exchange must be organized and have the capacity to carry out the purposes of the Act.[52] Specifically, an exchange must be able to enforce compliance by its members, and persons associated with its members, with the federal securities laws and the rules of the exchange.[53]

C2 has not proposed to be a party to any regulatory services agreements or bilateral plans for the allocation of regulatory responsibilities pursuant to Rule 17d-2 of the Act, though it will become a party to the existing multiparty options 17d-2 plans concerning sales practice regulation and market surveillance.[54]

C2 proposes to use "dual hat" employees to staff its regulatory program. In other words, current CBOE employees will also serve in a similar capacity for C2. Similar to other exchanges, C2 has proposed a requirement that confidential information (e.g., disciplinary matters, trading data, trading practices, and audit information) pertaining to the self-regulatory

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51 See BATS Exchange Registration Order, supra note 39, at 73 FR 49501; and Nasdaq Exchange Registration Order, supra note 39, at 71 FR 3554.

52 See Section 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1).

53 See id. See also Section 19(g) of the Act, 15 U.S.C. 78s(g).

54 See Securities Exchange Act Release Nos. 57987 (June 18, 2008), 73 FR 36156 (June 25, 2008) (File No. S7-966) (notice of filing and order approving and declaring effective an amendment to the multiparty 17d-2 plan concerning options-related sales practice matters); and 58765 (October 9, 2008), 73 FR 62344 (October 20, 2008) (File No. 4-551) (notice of filing and order approving and declaring effective an amendment to the multiparty 17d-2 plan concerning options-related market surveillance). See also infra Section III.C.3 (Multiparty 17d-2 Agreements); and 17 CFR 240.17d-2.

function of C2 will be retained in confidence by C2 and its officers, directors, employees, and agents.[55]

As discussed further below, the Commission believes that C2's application for registration describes a market structure that is designed to provide for sufficient regulatory oversight of C2 members and the operation of C2 as an SRO, as required by the Act. The Commission notes that C2 will have the statutory authority and responsibility to, among other things, discipline its members, amend its Bylaws and rules, list and delist securities, and grant or deny membership in C2. Further, the Commission believes that the use of "dual hat" employees by C2 is appropriate, as the operations, rules, and management of CBOE and C2 will overlap to a considerable degree such that C2 should benefit by leveraging the experience of current CBOE staff. However, the Commission expects both CBOE and C2 to monitor the workload of their dual hat employees and supplement their staffs if necessary so that C2 maintains sufficient personnel to allow it to carry out the purposes of the Act and enforce compliance with the rules of C2 and the federal securities laws.

1. Membership and Access

a. TPH Access

Membership on C2 will be available to any registered broker or dealer that meets the standards for membership set forth in Chapter 3 of C2's proposed rules.[56] Members will access C2 through trading permits, which will not convey any ownership interest in the Exchange but

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55 See Article Eleventh of the C2 Certificate of Incorporation. See also, e.g., Article VII of the Second Amended and Restated Operating Agreement of the New York Stock Exchange LLC (containing a similar provision).

56 See C2 Rule 3.1(b). If a TPH intends to transact business with the public, it will be required to obtain approval pursuant to C2 Rule 9.1 or must have been previously approved to transact business with the public by another national securities exchange. See id.

will confer the ability to transact on the Exchange. There is no limit on the number of permits that C2 is authorized to issue.[57] Permits will not be transferable except in the event of a change in control of a TPH, subject to meeting certain criteria.[58] There will be two types of TPHs: (1) market makers with certain affirmative and negative obligations and (2) regular TPHs.[59]

Each CBOE member in good standing will be eligible to obtain one trading permit on C2 regardless of the number of seats owned by that CBOE member.[60] CBOE member applicants will not be required to submit a full application for membership on C2, but rather will only need to complete selected forms concerning their election to trade on C2, consent to C2's jurisdiction, and other operational matters.[61] This waive-in process is similar to arrangements in place at other SROs.[62]

Non-CBOE members could apply for a C2 trading permit by submitting a full application to the Exchange in a manner similar to the current process for firms applying to membership on CBOE.[63] C2 will establish, and will distribute via regulatory circular, procedures that outline

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57 While C2 does not anticipate reaching any capacity limits, it has proposed a rule that will allow C2, in the event of a capacity restriction, to limit access to new market makers pursuant to a filing with the Commission. See C2 Rule 8.1(c). This proposed rule is similar to a rule of Nasdaq. See Nasdaq Rule Chapter VII, Section 2(c).

58 See C2 Rule 3.1(d).

59 See C2 Rules 3.1 and 8.1. See also Exhibit E to C2's Form 1 (describing the operation of the proposed Exchange).

60 See C2 Rule 3.1(c)(1).

61 See id.

62 See, e.g., Nasdaq Rule 1013(a)(5)(C) (containing a similar expedited waive-in membership process for members of the Financial Industry Regulatory Authority, Inc. ("FINRA")).

63 See C2 Rule 3.1(c)(2).

submission deadlines and payment of any applicable application fees.[64] Pursuant to C2's rules, every applicant must have and maintain membership in another options exchange that is registered under the Act and that is not registered solely under Section 6(g) of the Act.[65]

The Exchange will receive and review all trading permit applications, and will provide to the applicant written notice of the Exchange's determination, specifying in the case of disapproval of an application the grounds thereof.[66] The Exchange also will register and qualify associated persons of permit holders.[67] Once an applicant becomes a TPH or a person associated with a TPH, it must continue to satisfy all of the qualifications set forth in the C2 rules.[68] When the Exchange has reason to believe that a member or associated person or a member fails to meet such qualifications, the Exchange may suspend or revoke such person's membership or association.[69] Appeals from any denial, suspension, or conditional approval will be heard pursuant to the appeals process specified in Chapter 19.[70]

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64 See id. The Commission notes that C2 will be required to file any such proposed fees pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder, 15 U.S.C. 78s(b) and 17 CFR 240.19b-4, respectively.

65 See C2 Rule 3.1(c)(2)(G).

66 See C2 Rule 3.1(c)(2)(E) and (F). The Exchange also could condition an applicant's approval for the reasons specified in C2 Rule 3.2.

67 See C2 Rules 3.3 and 3.4. See also Amendment No. 1.

68 See C2 Rule 3.2(c)(1).

69 See, e.g., C2 Rule 3.2 (Denial of and Conditions to Being a Permit Holder or an Associated Person); 3.4 (Qualification and Registration); and 3.5 (Permit Holders and Persons Associated with a Permit Holder Who Are or Become Subject to a Statutory Disqualification). See also Amendment No. 1.

70 See infra note 117 (regarding Chapter 19). C2's Chapter 19 rules (Hearings and Review) incorporate by reference CBOE's Chapter 19 rules and C2 participants will be required to comply with CBOE Chapter 19 rules, as such rules may be in effect from time to time, as if such rules were part of the C2 rules.

The Commission finds that C2's membership rules are consistent with Section 6 of the Act,[71] including Section 6(b)(2) of the Act[72] in particular, which requires that a national securities exchange have rules that provide that any registered broker or dealer or natural person associated with such broker or dealer may become a member and any person may become associated with an exchange member. The Commission notes that pursuant to Section 6(c) of the Act,[73] an exchange must deny membership to any person, other than a natural person, that is not a registered broker or dealer, any natural person that is not, or is not associated with, a registered broker or dealer, and registered broker-dealers that do not satisfy certain standards, such as financial responsibility or operational capacity. As a registered exchange, C2 must independently determine if an applicant satisfies the standards set forth in the Act, regardless of whether an applicant is a member of another SRO (e.g., CBOE).[74]

b. Non-TPH Access

C2 proposes to permit access to non-TPH "Sponsored Users" whose access is authorized in advance by a TPH ("Sponsoring Participant").[75] C2's proposed "Sponsored Users" rule is similar to rules of other SROs that provide for sponsored access.[76] Specifically, the Sponsoring Participant must agree to be responsible for all orders entered into on C2 by the Sponsored User. In addition, Sponsored Users must agree to comply with all applicable rules of C2 governing the entry, execution, reporting, clearing, and settling of orders in securities eligible for trading on C2

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71 15 U.S.C. 78f.

72 15 U.S.C. 78f(b)(2).

73 15 U.S.C. 78f(c).

74 See, e.g., BATS Exchange Registration Order, supra note 39, at 73 FR 49502; and Nasdaq Exchange Registration Order, supra note 39, at 71 FR 3555.

75 See C2 Rule 3.15.

76 See, e.g., CBOE Rule 6.20A (Sponsored Users).

and the Sponsored User must agree that it will be bound by and comply with the Exchange's rules as if the Sponsored User were a Permit Holder.[77] Sponsored Participants will also be required by C2 rules to enter into a "Sponsored User Agreement" with their Sponsoring Permit Holder setting forth the obligations of both parties.

c. Linkage

C2 intends to become a participant in the Plan Relating to Options Order Protection and Locked/Crossed Markets or any successor plan ("Linkage Plan").[78] If admitted as a participant to the Linkage Plan, other plan participants (including CBOE) would be able to send orders to C2 in accordance with the terms of the Linkage Plan.

C2 will incorporate by reference the Intermarket Linkage rules contained in Section E of Chapter VI of CBOE's rulebook, as such rules may be in effect from time to time. Accordingly, C2's proposed Linkage rules will include relevant definitions, establish the conditions pursuant to which members may enter Linkage orders, impose obligations on the Exchange regarding how it must process incoming Linkage orders, establish a general standard that members and the Exchange should avoid trade-throughs, establish potential regulatory liability for members that engage in a pattern or practice of trading through other exchanges, and establish obligations with respect to locked and crossed markets.

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77 See C2 Rule 3.15(b)(1)(B)(iii).

78 See Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (File No. 4-546) (order approving the national market system Plan Relating to Options Order Protection and Locked/Crossed Markets Submitted by the Chicago Board Options Exchange, Incorporated, International Securities Exchange, LLC, The NASDAQ Stock Market LLC, NASDAQ OMX BX, Inc., NASDAQ OMX PHLX, Inc., NYSE Amex LLC, and NYSE Arca, Inc.) ("Linkage Plan").

The Commission believes that C2 has proposed rules that are designed to comply with the requirements of the Linkage Plan.[79] Further, before C2 can commence operations as an exchange, C2 must become a participant in the Linkage Plan.

d. Market Makers

i. Registration of Market Makers

A TPH may register with C2 as a market maker by filing a written application with C2, which will consider an applicant's market making ability and other factors it deems appropriate in determining whether to approve an applicant's registration.[80] All market makers will be designated as specialists on C2 for all purposes under the Act and rules thereunder.[81] C2 will not limit the number of qualifying entities that may become market makers.[82] The good standing of a market maker may be suspended, terminated, or withdrawn if the conditions for approval cease to be maintained or if the market maker violates any of its agreements with C2 or any provisions of the C2 rules.[83]

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79 The Commission notes that it has approved CBOE rules to accommodate the Linkage Plan. See Securities Exchange Act Release No. 60551 (August 20, 2009), 74 FR 43196 (August 26, 2009) (File No. SR-CBOE-2009-040). These amended rules will be incorporated by reference into C2's rulebook. See C2 Rules Chapter 6, Section E (Intermarket Linkage). See also infra Section IV (discussing the Section 36 exemption).

80 See C2 Rule 8.1(a). In considering a TPH's application for registration as a market maker on C2, the provision permitting the Exchange to consider "such other factors as the Exchange deems appropriate" must be applied consistent with the Act, including that the Exchange's rules must not be unfairly discriminatory.

81 See C2 Rule 8.1.

82 See C2 Rule 8.1(c). However, C2 may limit access to the C2 system based on system constraints, capacity restrictions, or other factors relevant to protecting the integrity of the system, pending action required to address the issue of concern. To the extent that C2 places limitations on access to the system on any TPH, such limits will be objectively determined and submitted to the Commission via a proposed rule change filed under Section 19(b) of the Act. See id.

83 See C2 Rule 8.4(b).

The Commission finds that C2's proposed market maker qualifications requirements are consistent with the Act. In particular, C2's rules provide an objective process by which a TPH could become a market maker on C2 and provide for appropriate continued oversight by the Exchange to monitor for continued compliance by market makers with the terms of their application for such status. The Commission notes that C2's proposed market maker registration requirements are similar to those of other options exchanges.[84]

ii. Market Maker Obligations

Pursuant to C2 rules, the transactions of a market maker in its market making capacity must constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market.[85] Among other things, a market maker must: (1) maintain a two-sided market on a continuous basis (defined as 99% of the time) in 60% of the series of each registered class that have a time to expiration of less than nine months;[86] (2) engage in dealings for their own accounts when there is a lack of price continuity, a temporary disparity between the supply of and demand for a particular option contract, or a temporary distortion of the price relationships between options contracts of the same class; (3) compete with other market makers; (4) update quotations in response to changed market conditions; (5) maintain active markets; and (6) make markets that will be honored for the number of contacts entered.[87] C2 will impose an upper limit on the aggregate number of market makers that may quote in each product ("Class Quoting Limit" or "CQL"). The CQL will be set at 50 market makers, and could be increased or

84 See, e.g., Nasdaq Rules, Chapter VII, Sections 2 and 4; Boston Options Exchange Rules, Chapter VI, Section 2; and International Securities Exchange Rule 804.

85 See C2 Rule 8.5(a).

86 While not specified in the rule text, the Commission notes that a market maker's quote would need to be represented by a size of at least 1 contract.

87 See C2 Rule 8.5(a) and Amendment No. 1.

decreased for an existing or new product.[88] If C2 finds any substantial or continued failure by a market maker to engage in a course of dealings as specified in Rule 8.5(a), then such market maker will be subject to disciplinary action, suspension, or revocation of registration in one or more of the securities in which the market maker is registered.[89] In addition, market makers must maintain minimum net capital in accordance with Commission and C2 rules.[90] Market makers must also maintain information barriers that are reasonably designed to prevent the misuse of material, non-public information.[91]

The Commission notes that market makers receive certain benefits for carrying out their responsibilities.[92] For example, a lender may extend credit to a broker-dealer without regard to the restrictions in Regulation T of the Board of Governors of the Federal Reserve System if the credit is used to finance the broker-dealer's activities as a specialist or market maker on a national securities exchange.[93] In addition, market makers are excepted from the prohibition in Section 11(a) of the Act.[94] The Commission believes that a market maker must have sufficient affirmative obligations, including the obligation to hold itself out as willing to buy and sell

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88 See C2 Rule 8.11. Any such changes to the CQL would be announced by C2 in an Information Circular, and would be filed with the Commission pursuant to Section 19(b)(1) of the Act (15 U.S.C. 78s(b)). See C2 Rule 8.11(b) and (c).

89 See C2 Rule 8.5(c).

90 See C2 Rule 8.4(a)(1).

91 See C2 Rule 8.9. The Commission notes that, as with any rule of an exchange, C2 will be responsible, pursuant to Sections 6 and 19 of the Act (15 U.S.C. 78f and 15 U.S.C. 78s, respectively), for enforcing compliance with Rule 8.9, which will require C2 to conduct periodic examinations of its market maker members with this rule.

92 See, e.g., Securities Exchange Act Release No. 57478 (March 12, 2008), 73 FR 14521, 14526 (March 18, 2008) (File No. SR-NASDAQ-2007-004) (approval order concerning the establishment of the NASDAQ Options Market LLC ("NOM")) ("NOM Approval Order") (discussing the benefits and obligations of market makers).

93 12 CFR 221.5(c)(6).

94 15 U.S.C. 78k(a).

options for its own account on a regular or continuous basis, to justify this favorable treatment.[95] The Commission further believes that the rules of all U.S. options markets need not provide the same standards for market maker participation, so long as they impose affirmative obligations that are consistent with the Act.[96] The Commission believes that C2's market maker participation requirements impose sufficient affirmative obligations on C2 market makers and, accordingly, that C2's requirements are consistent with the Act. In particular, the Commission notes that the Act does not mandate a particular market model for exchanges, and while market makers may become an important source of liquidity on C2, they will likely not be the only source as C2 is designed to match buying and selling interest of all participants on C2.[97] The Commission therefore believes that C2's proposed structure is consistent with the Act.

2. Regulatory Independence

C2 has proposed several measures to help ensure the independence of its regulatory function from its market operations and other commercial interests. The regulatory operations of C2 will be monitored by the Regulatory Oversight Committee ("ROC"). The ROC will consist of at least four directors, all of whom will be Non-Industry Directors and all of whom will be recommended by the Non-Industry Directors on the Nominating and Governance Committee for approval by the Board. The ROC generally will be responsible for monitoring the adequacy and effectiveness of the Exchange's regulatory program, assessing the Exchange's regulatory performance, and assisting the Board in reviewing the Exchange's regulatory plan and the

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95 See NOM Approval Order, supra note 92, at 73 FR 14526.

96 See id.

97 See, e.g., NOM Approval Order, supra note 92, at 73 FR 14527 (discussing NOM's single market maker requirement).

overall effectiveness of the Exchange's regulatory functions.[98] Further, a Chief Regulatory Officer of the Exchange will have general supervision over the Exchange's regulatory operations.[99] In addition, any revenues received by the Exchange from fees derived from its regulatory function or regulatory penalties will not be used for non-regulatory purposes.[100]

The Commission continues to be 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.[101] To this end, C2 Rule 3.2(f) provides that without the prior approval of the Commission, C2 or any entity with which it is affiliated will not directly acquire or maintain an ownership interest in a C2 member, and a C2 member will not be or become an affiliate of C2 or an affiliate of C2.[102]

The Commission believes that the Exchange's proposed provisions relating to the regulatory independence of the Exchange are consistent with the Act, particularly with Section 6(b)(1), which requires an exchange to be so organized and have the capacity to carry out the purposes of the Act.[103]

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98 See C2 Bylaws Article IV, Section 4.6.

99 See Cover letter accompanying Amendment No. 1 (representing that, while not specified as an officer in the proposed Bylaws, C2 will have a Chief Regulatory Officer).

100 See C2 Rule 2.3 and Amendment No. 1.

101 See, e.g., NYSE/Archipelago Merger Approval Order, supra note 39, at 71 FR 11263.

102 See C2 Rule 3.2(f). The rule would not prohibit a TPH from acquiring an equity interest in CBSX LLC and would not prohibit a TPH from being affiliated with One Chicago, LLC under limited conditions. See id.

103 15 U.S.C. 78f(b)(1).

3. Multiparty 17d-2 Agreements

Section 19(g)(1) of the Act[104] requires every SRO to examine its members and persons associated with its members and to enforce compliance with the federal securities laws and the SRO's own rules, unless the SRO is relieved of this responsibility pursuant to Section 17(d) of the Act.[105] Section 17(d) was intended, in part, to eliminate unnecessary multiple examinations and regulatory duplication with respect to members of more than one SRO ("common members").[106] Rule 17d-2 of the Act permits SROs to propose joint plans allocating regulatory responsibilities concerning common members.[107] These agreements, which must be filed with and approved by the Commission, generally cover such regulatory functions as personnel registration and sales practices. Commission approval of a 17d-2 plan relieves the specified SRO of those regulatory responsibilities allocated by the plan to another SRO.[108] Many SROs have entered into 17d-2 agreements.[109] C2 currently does not intend to enter into any bilateral 17d-2 agreements, but rather will retain direct responsibility for all aspects of its operations as an SRO through the use of CBOE "dual hat" employees.[110] C2 does, however, plan to join the

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104 15 U.S.C. 78s(g)(1).

105 15 U.S.C. 78q(d).

106 See Securities Exchange Act Release No. 12935 (October 28, 1976), 41 FR 49091 (November 8, 1976) ("Rule 17d-2 Adopting Release").

107 17 CFR 240.17d-2.

108 See Rule 17d-2 Adopting Release, supra note 106.

109 See, e.g., Securities Exchange Act Release Nos. 59218 (January 8, 2009), 74 FR 2143 (January 14, 2009) (File No. 4-575) (FINRA/Boston Stock Exchange, Inc.); 58818 (October 20, 2008), 73 FR 63752 (October 27, 2008) (File No. 4-569) (FINRA/BATS Exchange, Inc.); 55755 (May 14, 2007), 72 FR 28057 (May 18, 2007) (File No. 4-536) (National Association of Securities Dealers, Inc. ("NASD") n/k/a FINRA and CBOE concerning the CBOE Stock Exchange); 55367 (February 27, 2007), 72 FR 9983 (March 6, 2007) (File No. 4-529) (NASD/International Securities Exchange, LLC); and 54136 (July 12, 2006), 71 FR 40759 (July 18, 2006) (File No. 4-517) (NASD/Nasdaq).

110 See supra text accompanying note 55 (regarding dual hat employees).

existing multiparty agreements concerning intermarket options surveillance.[111] Under these agreements, the examining SROs will examine firms that are common members of C2 and the particular examining SRO for compliance with certain provisions of the Act, certain rules and regulations adopted thereunder, and certain C2 rules.

4. Discipline and Oversight of Members

As noted above, one prerequisite for Commission approval of an exchange's application for registration is that a proposed exchange must be organized and have the capacity to carry out the purposes of the Act. Specifically, an exchange must be able to enforce compliance by its members and persons associated with its members with federal securities laws and the rules of the exchange.[112]

C2 proposed to incorporate by reference[113] Chapter 17 of the CBOE rulebook relating to member discipline. As such, C2 members will be required to comply with Chapter 17 of the CBOE rulebook as such rules may be in effect from time to time, as if such rules were part of the C2 rulebook. In addition, C2 proposes to use "dual hat" employees, i.e., current CBOE employees who will also serve in a similar capacity for C2, to administer its disciplinary and oversight functions. These C2 employees will, among other things, investigate potential

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111 See Securities Exchange Act Release Nos. 57987 (June 18, 2008), 73 FR 36156 (June 25, 2008) (File No. S7-966) (notice of filing and order approving and declaring effective an amendment to the multiparty 17d-2 plan concerning options-related sales practice matters) and 58765 (October 9, 2008), 73 FR 62344 (October 20, 2008) (File No. 4-551) (notice of filing and order approving and declaring effective an amendment to the multiparty 17d-2 plan concerning options-related market surveillance). See also Cover letter accompanying Amendment No. 1 (representing that C2 intends to join the options multiparty agreements).

112 See 15 U.S.C. 78f(b)(1).

113 See infra Section IV (discussing an exemption from Section 19(b) of the Act for CBOE rules incorporated by reference by C2). Citations to incorporated CBOE rules herein are referred to as "C2" rules.

securities laws violations, issue complaints, conduct hearings, and issue disciplinary decisions pursuant to C2 rules.[114]

Upon petition, appeals from disciplinary decisions rendered by C2 will be heard by the Board (or a committee of the Board composed of at least three directors whose decision will need to be ratified by the Board) and the Board's decision will be final.[115] In addition, the Board may on its own initiative order review of a disciplinary decision.[116]

Appeal of a denial, suspension, or termination of a trading permit will be heard by the Exchange's Appeals Committee.[117] Decisions of the Appeals Committee will be made in writing and will be sent to the parties to the proceeding.[118] The decisions of the Appeals Committee will be subject to review by the Board, on its own motion, or upon written request by the aggrieved party, the President of C2, or by the Chairman of the committee whose action was subject to the prior review of the Appeals Committee.[119] The Board, or a committee of the Board, will have sole discretion to grant or deny the request.[120] The Board, or a committee of the Board, will

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114 See C2 Rules 17.2 – 17.9.

115 See C2 Rule 17.10(b).

116 See C2 Rule 17.10(c).

117 See C2 Rule 19.4. The Commission notes that C2's Chapter 19 rules (Hearings and Review) incorporate by reference CBOE's Chapter 19 rules and C2 participants will be required to comply with CBOE Chapter 19 rules, as such rules may be in effect from time to time, as if such rules were part of the C2 rules. Further, the Commission notes that C2 will establish its own Appeals Committee that includes C2 participants. See Cover letter accompanying Amendment No. 1 (representing that C2 will establish its own Appeals Committee).

118 See C2 Rule 19.4(e).

119 See C2 Rule 19.5(a).

120 See id.

conduct the review of the Appeals Committee's decision and the Board may affirm, reverse, or modify the Appeals Committee's decision.[121]

C2 rules codify the Exchange's disciplinary jurisdiction over its members, thereby facilitating its ability to enforce its members' compliance with its rules and the federal securities laws.[122] The Exchange's rules also permit it to sanction members for violations of its rules and violations of the federal securities laws by, among other things, expelling or suspending members; limiting members' activities, functions, or operations; fining or censuring members; suspending or barring a person from being associated with a member; or any other appropriate sanction.[123]

The Commission finds that C2's proposed disciplinary and oversight rules and structure are consistent with the requirements of Sections 6(b)(6) and 6(b)(7) of the Act[124] in that they provide fair procedures for the disciplining of members and persons associated with members. The Commission further finds that the proposed C2 rules are designed to provide the Exchange with the ability to comply, and with the authority 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 C2.[125]

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121 See C2 Rule 19.5(b). Decisions concerning denial of membership in an exchange are subject to review by the Commission.

122 See generally C2 Rule 17.1.

123 See C2 Rule 17.11.

124 15 U.S.C. 78f(b)(6) and (b)(7), respectively.

125 See Section 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1).

D. The C2 Trading System

1. Order Display, Execution, and Priority

C2 will operate a fully-automated electronic platform for trading standardized options with a continuous, automated matching function. Liquidity will be derived from market maker quotes as well as orders to buy and sell submitted to C2 electronically by users (collectively, "Participants"). There will be no physical trading floor.

All orders/quotes submitted to C2 will be displayed unless designated otherwise by the Participant submitting the order (e.g., the non-displayed portion of a Reserve Order). The Exchange has represented that any top-of-book feed (or comparable market data feed) that it makes available to C2 members will also be made available to other market participants.[126]

Non-displayed orders will not be displayed to any Participants and will not have time priority over displayed orders.[127] While orders will generally be submitted on an anonymous basis, C2 will allow Participants on a voluntary basis to submit Attributable Orders, which will display the firm's identity along with the order to all market participants simultaneously.[128] In addition, Participants will be able to submit the following types of orders to C2: Day; Good 'til Canceled; Contingency (including All-Or-None, Immediate Or Cancel, Market On Close, Fill Or Kill, Stop, and Reserve); and Complex Orders (including Spreads, Combination, Straddle,

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126 See Cover letter accompanying Amendment No. 1 (representing that the Exchange will offer the data feed to all market participants). The Exchange noted that it may adopt fees for non-member access to a C2 data feed. See id. The Commission notes that C2 would be required to file any such proposed fees pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder, 15 U.S.C. 78s(b) and 17 CFR 240.19b-4, respectively.

127 See C2 Rule 6.12(a).

128 NOM offers a similar attributable order type. See NOM Approval Order, supra note 92, at 73 FR 14528 (discussing NOM's attributable order type).

Strangle, Ratio, Butterfly, Box/Roll, Collar and Risk Reversal).[129] The Commission notes that these order types are substantially similar to the order types offered by CBOE.[130]

The Commission believes that C2's proposed order types are consistent with the Act. Among other things, the Commission believes that C2's proposed order types appropriately provide priority to displayed orders and portions of orders over non-displayed orders and portions of orders, thereby encouraging the posting of displayed orders, which contribute visible depth to the displayed market.[131]

After the open, trades on C2 will execute when a buy order/quote and a sell order/quote match on C2's order book. All orders will be matched according to one of two priority structures, as determined by C2 on a class-by-class basis: (1) price-time priority or (2) pro-rata priority.[132] In addition, public customer and/or market turner priority[133] overlays will also be

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129 See C2 Rule 6.10 (Order Types Defined) for additional information on each order type. See also Amendment No. 1 (revising the definition of Ratio Order).

130 See CBOE Rules 6.53 and 6.53C.

131 See, e.g., Securities Exchange Act Release Nos. 37619A (September 6, 1996), 61 FR 48290, 48294 (September 12, 2006) (File No. 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."); and 57441 (March 6, 2008), 73 FR 13267 (March 12, 2008) (File No. SR-ISE-2007-95) (noting the incentive for market participants to display their trading interest in the context of reserve orders).

132 Under pro rata priority, orders will be prioritized according to price. If there are two or more orders at the best price then trades will be allocated proportionally according to size. See C2 Rule 6.12(a)(2).

133 C2 defines a "market turner" as a party that was the first to enter an order or quote at a better price than the previous best disseminated Exchange price and the order/quote is continuously in the market until it trades. The market turner priority at a given price could only be established after the opening rotation and would remain with the order once it is earned and last until the conclusion of the trading session. See C2 Rule 6.12(b)(2).

available at C2's discretion on a series-by-series basis.[134] In the event that less than the full size of an order is executed, the unexecuted portion of the order will continue to reside on C2's order book. The non-reserve portion of any partially-executed order will retain priority at the same price. Regardless of the priority structure, Contingency Orders will be last in priority because they are not displayed.

C2 will limit a Participant's ability to trade as principal with an order it represents as agent, unless the agency order is first given the opportunity to interact with other trading interest on the Exchange. Specifically, in order to trade as principal with an agency order a Participant represents, either: (1) the agency order is first exposed on C2 for at least 1 second;[135] (2) the Participant has been bidding or offering for at least 1 second prior to receiving an agency order that is executable against its bid or offer; or (3) the Participant uses the Automated Improvement Mechanism or Solicitation Auction Mechanism.[136]

C2 may offer a Simple Auction Liaison ("SAL") system to auction eligible agency orders and provide the opportunity for price improvement better than the NBBO.[137] C2 would designate the eligible order size, order type, and origin code (i.e., public customer, non-market maker broker-dealer, or market maker order), and classes in which SAL may be activated. For

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134 C2 will issue a Regulatory Circular periodically that will specify which series are subject to these additional priorities, and will update the Regulatory Circular any time it makes a change to any of the designated priorities. See C2 Rule 6.12(b).

135 All-or-none contingency orders on C2 will not be deemed "exposed" for purposes of Rule 6.50. See C2 Rule 6.50(c) and Amendment No. 1.

136 See C2 Rule 6.50. See also proposed C2 Rule 1.1 (defining NBBO as the national best bid or offer). For purposes of the order exposure requirements contained in C2 Rule 6.50, all-or-none orders are not deemed exposed. See C2 Rule 6.50(c). The 1 second exposure period is consistent with the operation of the CBOE Hybrid System. See CBOE Rule 6.45A Interpretations and Policies .01 and .02 (regarding the 1 second exposure on the CBOE Hybrid System).

137 See C2 Rule 6.14. C2's SAL is based on CBOE's SAL rule. See CBOE Rule 6.13A.

classes in which SAL is activated, SAL will automatically initiate an auction process for a non-contingency order that is marketable against C2's NBBO quote, except when C2's disseminated quote on the opposite side does not contain sufficient market-maker quotation size to satisfy the entire order. Prior to commencing an auction, SAL would stop the order at the NBBO against the market maker quotes displayed at the NBBO on the opposite side. SAL auctions will last for a period of time not to exceed 2 seconds. Auction responses could be submitted by any Participant.[138] At the end of the auction, the agency order will first be allocated against public customer interest at the best price. Any remaining balance of the agency order will then be allocated pursuant to the matching algorithm in effect for the class.[139]

The Automated Improvement Mechanism ("AIM") will allow Participants to cross an agency order they hold against principal interest or a solicited order provided that they first expose the agency order to a 1-second auction.[140] To be eligible for an AIM auction, at least three market makers must be quoting in the applicable series.[141] If the agency order is greater than 50 contracts, the Participant must stop the agency order at the NBBO (or the order's limit price if better), and if it is less than 50 contracts, the Participant must stop the agency order at the NBBO improved by one minimum increment (or the order's limit price if better).[142] When initiating an auction, a Participant submitting an agency orders to AIM must either indicate a single-price at which it seeks to cross the order or must indicate that it will match as principal the

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138 See C2 Rule 6.14(b) and Amendment No. 1.

139 See C2 Rule 6.14. See also CBOE Rule 6.13A.

140 See C2 Rule 6.51.

141 See C2 Rule 6.51(a)(4).

142 See C2 Rule 6.51(a)(2) and (3).

price and size of all auction responses.[143] Request for responses will then be sent to any Participant that has elected to receive such requests, and the exposure period will last for 1 second.[144] If the auction attracts responses (which may be submitted by Participants),[145] the agency order will be allocated at the best price(s), and public customer orders in the book will have priority.[146] If the best price equals the initiating Participant's single-price submission, then the initiating Participant will be allocated 40% of the order (or 50% in the case of a single price submission where only one other market maker matches the price).[147] C2's proposed AIM is based on CBOE's AIM rule.[148]

C2's Solicitation Auction Mechanism ("SAM") is based on CBOE's SAM.[149] The SAM will allow Participants to execute agency orders of 500 or more contracts against solicited orders after a 1-second auction exposure. The orders must be designated as all-or-none, and the initiating Participant must signify a single price at which it seeks to cross the order. At the conclusion of the auction, the agency order will trade with the solicited order provided that the trade price of the agency order is equal to or better than C2's best bid or offer.[150] Further, if there are any public customer orders resting in the book on the opposite side at the execution price with sufficient size to fill the agency order, then the agency order will be executed against the public customer interest and the solicited order will be cancelled. If the public customer

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143 See C2 Rule 6.51(b)(1).

144 See id.

145 See C2 Rule 6.51(b)(1)(D) and Amendment No. 1.

146 See C2 Rule 6.51(b)(3) and Amendment No. 1.

147 See id.

148 See C2 Rule 6.51. See also CBOE Rule 6.74A.

149 See C2 Rule 6.52. See also CBOE Rule 6.74B.

150 See C2 Rule 6.52(b)(2)(A)(i). If the trade would take place at a price outside of the C2 best bid or offer, then the agency order and solicited order would cancel. See id.

order lacks sufficient size, then the agency order and solicited order will be cancelled. Likewise, if the auction generates a response at an improved price that contains sufficient size to fill the agency order, then the agency order will execute against the improved price and the solicited order will be cancelled.[151]

C2 also will make available certain additional order processing and matching features. For example, C2 will maintain a complex order book ("COB") that permits any C2 market participant to enter complex orders into the COB to automatically execute against marketable orders and quotes resting in the book or against other complex orders in the COB.[152] In addition, C2 will offer an optional complex order auction that will allow orders, prior to routing to the COB, to be auctioned for price improvement through an automated request for response auction process, subject to certain conditions.[153] C2's complex order execution rule is based on CBOE's rule.[154]

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151 See C2 Rule 6.52(b)(2)(A)(ii)-(iii). If the response does not contain sufficient size, then the agency order will trade with the solicited order. See id.

152 See C2 Rule 6.13(b). See also C2 Rule 6.12(g) and Amendment No. 1 (regarding complex order priority). Orders entered by any C2 market participant also may rest in the COB.

153 See C2 Rule 6.13(c). See also C2 Rule 6.12(g) and Amendment No. 1 (a complex order may be executed at a net debit or credit price without giving priority to equivalent bids (offers) in the individual series legs that are represented in the System provided at least one leg of the order betters the best corresponding public customer bid (offer) in the system by at least one minimum trading increment or, if COB or COA are activated for all market participants in the subject option class, a $0.01 increment to be determined by C2 on a class-by-class basis); and C2 Rule 4.18 (prohibiting the misuse of material, nonpublic information as such would be applicable in the context of preventing the disclosure of nonpublic information about a complex order auction).

154 See CBOE Rule 6.53C. As on CBOE, on C2, a member seeking to trade with its customer's complex order would be required to comply with C2 Rule 6.50(a), and a member seeking to cross its customer's complex order with solicited orders would be required to comply with C2 Rule 6.50(b). In addition, the complex order priority provision in C2 Rule 6.12(g) will apply to complex orders.

Finally, C2 has proposed a rule prohibiting trading on knowledge of imminent undisclosed solicited transactions, otherwise known as the "anticipatory hedge" rule.[155] Pursuant to this rule, it will be considered conduct inconsistent with just and equitable principles of trade and a violation of Rule 4.1 for any Participant or person associated with a Participant, who has knowledge of all material terms and conditions of an original order and a solicited order, including a facilitation order, that matches the original order's limit, the execution of which are imminent, to enter, based on such knowledge, an order to buy or sell an option of the same class as an option that is the subject of the original order, or an order to buy or sell the security underlying such class, or an order to buy or sell any related instrument until either (i) all the terms and conditions of the original order and any changes in the terms and conditions of the original order of which that member or associated person has knowledge are disclosed to the trading crowd or (ii) the solicited trade can no longer reasonably be considered imminent in view of the passage of time since the solicitation.

For the reasons discussed above, the Commission believes that C2's proposed display, execution, and priority rules are consistent with the Act. In particular, the Commission finds that the proposed rules are consistent with Section 6(b)(5) of the Act,[156] which, among other things, requires that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating 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 to not permit unfair discrimination between customers, issuers, or dealers. The

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155 See C2 Rule 6.55. See also Amendment No. 1 (containing the proposed rule).

156 15 U.S.C. 78f(b)(5).

Commission also finds that the proposed rules are consistent with Section 6(b)(8) of the Act,[157] 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. In particular, the Commission believes that the proposed matching mechanisms should facilitate the prompt execution of orders, while providing Participants with an opportunity to compete for exposed bids and offers.[158]

2. Opening

C2 will employ an opening process that is designed to match the greatest number of pending buy and sell orders.[159] Prior to opening a series, C2 will make available to all Participants the expected opening price and size, which should help attract additional orders that, in turn, could offset any imbalances at the open.[160] After the start of trading in the underlying security, the Exchange will open each series at a price that executes the greatest amount of pre-opening interest and that does not trade-through the NBBO (if one exists).[161] The Commission believes that C2's opening rules are designed to conduct the opening on C2 in a fair and orderly fashion and are consistent with the Act.

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157 15 U.S.C. 78f(b)(8).

158 See, e.g., Securities Exchange Act Release No. 58088 (July 2, 2008), 73 FR 39747 (July 10, 2008) (File No. CBOE-2008-16) (order approving a proposal to reduce certain order exposure times).

159 C2 will accept pre-opening orders. See C2 Rule 6.11(a).

160 See C2 Rule 6.11(a) and Amendment No. 1.

161 See C2 Rule 6.11.

3. Obvious and Catastrophic Errors

C2 proposed an obvious and catastrophic error rule based on the corresponding rule of the International Securities Exchange, LLC.[162] The Commission believes that in most circumstances trades that are executed between parties should be honored. On rare occasions, the price of the executed trade indicates an "obvious" or "catastrophic" error may exist, suggesting that it is unlikely that the parties to the trade had come to a meeting of the minds regarding the terms of the transaction. In the Commission's view, the determination of whether an error has occurred should be based on specific and objective criteria and subject to specific and objective procedures.[163] The Commission believes that C2's proposed obvious error rule provides clear and objective standards and procedures for determining whether an obvious error has occurred, is consistent with the Act, and is substantively the same as obvious error rules previously approved by the Commission for other exchanges.[164]

4. Section 11(a) of the Act

Section 11(a)(1) of the Act[165] prohibits a member of a national securities exchange from

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162 See C2 Rule 6.15 and Amendment No. 1. See also International Stock Exchange Rule 720. With respect to no bid series, C2's rule provides that transactions in series quoted no bid and $0.05 or less offer can be nullified provided, among other things, that at least one strike price below (for calls) or above (for puts) in the same options class was quoted zero bid and $0.05 or less offer at the time of execution. ISE Rule 720 requires two such strikes below (for calls) or above (for puts). See Securities Exchange Act Release No. 59548 (March 10, 2009), 74 FR 11147 (March 16, 2009) (File No. SR-ISE-2009-10) (notice of filing and immediate effectiveness of proposed rule change to amend ISE's obvious error rule). C2's rule is similar to NYSE Arca Rule 6.87 (Obvious Errors and Catastrophic Errors) in that it only provides for one strike. See also CBOE Rule 6.25 (Nullification and Adjustment of Equity Options Transactions).

163 See NOM Approval Order, supra note 92, at 73 FR 14532.

164 See, e.g., Securities Exchange Act Release No. 57398 (February 28, 2008), 73 FR 12240 (March 6, 2008) (File No. SR-ISE-2007-112) (order approving amendments to ISE Rule 720).

165 15 U.S.C. 78k(a)(1).

effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, "covered accounts") unless an exception applies. Rule 11a2-2(T) under the Act,[166] known as the "effect versus execute" rule, provides exchange members with an exemption from the Section 11(a)(1) prohibition. Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute transactions on the exchange. To comply with Rule 11a2-2(T)(a)(2)'s conditions, a member: (i) may not be affiliated with the executing member; (ii) must transmit the order from off the exchange floor; (iii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;[167] and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the Rule.

In a letter to the Commission, C2 requests that the Commission concur with C2's conclusion that Participants that enter orders into C2 satisfy the requirements of Rule 11a2-2(T).[168] For the reasons set forth below, the Commission believes that Participants entering orders into C2 would satisfy the conditions of the Rule.

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166 17 CFR 240.11a2-2(T).

167 The member may, however, participate in clearing and settling the transaction. See 1978 Release, infra note 173.

168 See Letter from Angelo Evangelou, Assistant General Counsel, CBOE, to Elizabeth King, Associate Director, Division of Trading and Markets, Commission, dated October 16, 2009 ("C2 11(a) Letter").

The Rule's first condition is that the order be executed by an exchange member who is unaffiliated with the member initiating the order.[169] The Commission has stated that this requirement is satisfied when automated exchange facilities, such as the C2 system, are used, as long as the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange.[170] C2 has represented that the design of the C2 system ensures that no member has any special or unique trading advantage in the handling of its orders after transmitting its orders to C2.[171] Based on C2's representation, the Commission believes that the C2 system satisfies this requirement.

Second, the Rule requires that orders for covered accounts be transmitted from off the exchange floor.[172] The C2 system receives orders electronically through remote terminals or computer-to-computer interfaces. In the context of other automated trading systems, the Commission has found that the off-floor transmission requirement is met if a covered account order is transmitted from a remote location directly to an exchange's floor by electronic means.[173] Because the C2 system receives orders electronically through remote terminals or

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169 17 CFR 240.11a2-2(T)(a)(2)(i).

170 See, e.g., NOM Approval Order, supra note 92, at note 269 (citing to the 1979 Release). In considering the operation of automated execution systems operated by an exchange, the Commission noted that while there is not an independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See 1979 Release, infra note 173.

171 See C2 11(a) Letter, supra note 168.

172 17 CFR 240.11a2-2(T)(a)(2)(ii).

173 See, e.g., NOM Approval Order, supra note 92, at 73 FR 14538; Nasdaq Exchange Registration Order, supra note 39, at 71 FR 3560; and Securities Exchange Act Release Nos. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (File No. SR–BSE–2002–15) (order approving the rules of the Boston Options Exchange); 44983 (October

computer-to-computer interfaces, the Commission believes that the C2 system satisfies the off-floor transmission requirement.[174]

Third, the Rule requires that the member not participate in the execution of its order.[175] C2 represented that at no time following the submission of an order is a Participant able to acquire control or influence over the result or timing of an order's execution. According to C2, the execution of a member's order is determined solely by what other orders, bids, or offers are present in the C2 system at the time the Participant submits the order and on the priority of those orders, bids, and offers.[176] Based on these representations, the Commission believes that a Participant does not participate in the execution of an order submitted to the C2 system.

Fourth, in the case of a transaction effected for an account with respect to which the initiating member or an associated person thereof exercises investment discretion, neither the

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25, 2001), 66 FR 55225 (November 1, 2001) (File No. SR-PCX-00-25) (order approving the Archipelago Exchange as an electronic trading facility of the Pacific Exchange ("PCX")); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (File Nos. SR-NYSE-90-52 SR-NYSE-90-53) (regarding NYSE's Off-Hours Trading Facility); 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) (File No. S7-163) (regarding the American Stock Exchange Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX Communications and Execution System, and the Philadelphia Stock Exchange's Automated Communications and Execution System ("1979 Release")); and 14563 (March 14, 1978) 43 FR 11542 (March 17, 1978) (File No. S7-163) (regarding the NYSE's Designated Order Turnaround System ("1978 Release")).

174 See, e.g., NOM Approval Order, supra note 92, at 73 FR 14538-39.

175 17 CFR 240.11a2-2(T)(a)(iii).

176 See C2 11(a) Letter, supra note 168. The Participant may cancel or modify the order, or modify the instruction for executing the order, but only from off the floor. The Commission has stated that the non-participation requirement is satisfied under such circumstances so long as such modifications or cancellations are also transmitted from off the floor. See 1978 Release, supra note 173 (stating that the "non-participation requirement does not prevent initiating members from canceling or modifying orders (or the instructions pursuant to which the initiating member wishes orders to be executed) after the orders have been transmitted to the executing member, provided that any such instructions are also transmitted from off the floor").

initiating member nor any associated person thereof may retain any compensation in connection with effecting the transaction, unless the person authorized to transact business for the account has expressly provided otherwise by written contract referring to Section 11(a) of the Act and Rule 11a2-2(T).[177] Participants trading for covered accounts over which they exercise investment discretion must comply with this condition in order to rely on the rule's exemption.[178]

E. Listing Procedures

C2 will incorporate by reference CBOE's listing rules for options.[179] As such, the Commission finds that C2's proposed initial and continued listing rules, which are based on CBOE rules previously approved by the Commission, are consistent with the Act, including Section 6(b)(5), in that they are designed to protect investors and the public interest and to promote just and equitable principles of trade. The Commission notes that, before beginning operation, C2 will need to become a participant in the Plan for the Purpose of Developing and Implementing Procedures Designed to Facilitate the Listing and Trading of Standardized Options Submitted Pursuant to Section 11A(a)(3)(B) of the Securities Exchange Act of 1934 ("OLPP"). In addition, before beginning operation, C2 will need to become a participant in the Options Clearing Corporation.

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177 17 CFR 240.11a2-2(T)(a)(2)(iv). In addition, Rule 11a2-2(T)(d) requires a member or associated person authorized by written contract to retain compensation, in connection with effecting transactions for covered accounts over which such member or associated persons thereof exercises investment discretion, to furnish at least annually to the person authorized to transact business for the account a statement setting forth the total amount of compensation retained by the member in connection with effecting transactions for the account during the period covered by the statement. See 17 CFR 240.11a2-2(T)(d). See also 1978 Release, supra note 173 (stating "[t]he contractual and disclosure requirements are designed to assure that accounts electing to permit transaction-related compensation do so only after deciding that such arrangements are suitable to their interests.").

178 See C2 11(a) Letter, supra note 168.

179 See infra Section IV (discussing an exemption from Section 19(b) of the Act for CBOE rules incorporated by reference by C2). See also C2 Rules Chapter 5.

IV. Exemption from Section 19(b) of the Act with Regard to CBOE Rules Incorporated by Reference

C2 proposes to incorporate by reference certain CBOE rules as C2 rules, including Chapters 4 (Business Conduct), 5 (Securities Dealt In), 6 Section E (Intermarket Linkage), 9 (Doing Business with the Public), 10 (Closing Transactions), 11 (Exercises and Deliveries), 12 (Margins), 13 (Net Capital Requirements), 15 (Records, Reports and Audits), 16 (Summary Suspension by Chairman of the Board or Vice Chairman of the Board), 17 (Discipline), 18 (Arbitration), 19 (Hearings and Review), and 24 (Index Options). In each Chapter including incorporated rules, C2 states that these such rules "as such rules may be in effect from time to time, shall apply to C2 and are hereby incorporated into this Chapter" and that C2 members shall comply with a C2 rule by complying with the CBOE rules incorporated by reference "as if such rules were part of the C2 Rules."[180] In connection with its proposal to incorporate certain CBOE rules by reference, C2 requested, pursuant to Rule 0-12,[181] an exemption under Section 36 of the Act[182] from the rule filing requirements of Section 19(b) of the Act for changes to those C2 rules that are affected solely by virtue of a change to a cross-referenced CBOE rule. C2 proposes to incorporate by reference categories of rules (rather than individual rules within a category) that are not trading rules. C2 also agrees to provide written notice to its members whenever CBOE proposes a rule change to a CBOE rule that C2 has incorporated by reference.[183]

Using its authority under Section 36 of the Act, the Commission previously exempted several other SROs from the requirement to file proposed rule changes under Section 19(b) of

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180 See, e.g., C2 Rules Chapter 4 (Business Conduct).

181 See 17 CFR 240.0-12.

182 15 U.S.C. 78mm.

183 See Letter from Angelo Evangelou, Assistant General Counsel, CBOE, to Elizabeth M. Murphy, Secretary, Commission, dated October 16, 2009.

the Act.[184] Each such exempt SRO agreed to be governed by the incorporated rules, as amended from time to time, but is not required to file a separate proposed rule change with the Commission each time the SRO whose rules are incorporated by reference seeks to modify its rules. In addition, each such exempt SRO incorporated by reference only regulatory rules (i.e., margin, suitability, arbitration), not trading rules, and incorporated by reference whole categories of rules. Each such exempt SRO had reasonable procedures in place to provide written notice to its members each time a change is proposed to the incorporated rules of another SRO in order to provide its members with notice of a proposed rule change that affects their interests, so that they would have an opportunity to comment on it.

The Commission is granting C2's request for exemption, pursuant to Section 36 of the Act, from the rule filing requirements of Section 19(b) of the Act with respect to the rules that C2 proposes to incorporate by reference. This exemption is conditioned upon C2 providing written notice to its members whenever CBOE proposes to change a rule that C2 has incorporated by reference. The Commission believes that this exemption is appropriate in the public interest and consistent with the protection of investors because it will promote more efficient use of Commission and SRO resources by avoiding duplicative rule filings based on simultaneous changes to identical rules sought by more than one SRO. Consequently, the Commission grants C2's exemption request.

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184 See, e.g., Securities Exchange Act Release No. 49260 (February 17, 2004), 69 FR 8500 (February 24, 2004) (order granting application for exemptions pursuant to Section 36(a) of the Act by the American Stock Exchange LLC, the International Securities Exchange, Inc., the Municipal Securities Rulemaking Board, the Pacific Exchange, Inc., the Philadelphia Stock Exchange, Inc., and the Boston Stock Exchange, Inc.); and Nasdaq Exchange Registration Order, supra note 39, at 71 FR 3565-66.

V. Conclusion

IT IS ORDERED that the application of C2 for registration as a national securities exchange be, and hereby is, granted.

IT IS FURTHER ORDERED that operation of C2 is conditioned on the satisfaction of the following requirements:

A. Participation in National Market System Plans Relating to Options Trading. C2 must join: (1) the Plan for the Reporting of Consolidated Options Last Sale Reports and Quotation Information (i.e., the Options Price Reporting Authority); (2) the OLPP; (3) the Linkage Plan;[185] and (4) the Plan of the Options Regulatory Surveillance Authority.

B. Participation in Multiparty 17d-2 Plans. C2 must become a party to the multiparty 17d-2 agreements concerning sales practice regulation and market surveillance.[186]

C. Participation in the Options Clearing Corporation. C2 must join the Options Clearing Corporation.

D. Participation in the Intermarket Surveillance Group. C2 must join the Intermarket Surveillance Group.

E. Examination by the Commission. C2 must have, and represent in a letter to the staff in the Commission's Office of Compliance Inspections and Examinations that it has, adequate procedures and programs in place to effectively regulate C2.

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185 See Linkage Plan, supra note 78.

186 See supra note 111 (citing to the most recent versions of the two plans). See also infra Section III.C.3 (Multiparty 17d-2 Agreements); and 17 CFR 240.17d–2.

IT IS FURTHER ORDERED, pursuant to Section 36 of the Act,[187] that C2 shall be exempt from the rule filing requirements of Section 19(b) of the Act[188] with respect to the CBOE rules C2 proposes to incorporate by reference into C2's rules, subject to the conditions specified in this Order.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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187 15 U.S.C 78mm.

188 15 U.S.C 78s(b).

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 61134 / December 10, 2009

Admin. Proc. File No. 3-12668

In the Matter of the Application of

JAMES GERARD O'CALLAGHAN
c/o Andrew J. Goodman
James H. Freeman
Garvey Schubert Barer
100 Wall Street, 20th Floor
New York, NY 10005

For Review of Disciplinary Action Taken by

NYSE Regulation, Inc.

OPINION OF THE COMMISSION

NATIONAL SECURITIES EXCHANGE – REVIEW OF DISCIPLINARY PROCEEDINGS

Sanctions Imposed by National Securities Exchange on Remand

Exchange member violated federal securities laws and exchange rules when he initiated and executed trades in an account over which he had investment discretion. *Held*, exchange's sanctions *sustained*.

APPEARANCES:

Andrew J. Goodman and *James H. Freeman*, of Garvey Schubert Barer, for James Gerard O'Callaghan.

Virginia J. Harnisch and *W. Kwame Anthony*, for NYSE Regulation, Inc.

Appeal filed: February 11, 2009
Last brief received: September 3, 2009

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I.

James Gerard O'Callaghan, formerly a New York Stock Exchange, Inc. ("NYSE" or "Exchange") member and an independent floor broker, has appealed a decision by the NYSE, on remand from the Commission, upholding the sanctions originally imposed. The NYSE found that O'Callaghan violated Section 11(a) and Rule 11a-1 of the Securities Exchange Act of 1934,[1] as well as NYSE Rules 90(a), 95(a), and 476(a)(6),[2] for having initiated and executed trades for an account over which he had investment discretion. The NYSE censured O'Callaghan, fined him $30,000, and suspended him for three months from membership, allied membership, approved person status, and from employment or association in any capacity with any member or member organization.

On appeal, we sustained the Exchange's findings of violation but remanded the case to the Exchange for it to reconsider the sanctions ("May 20, 2008 Opinion").[3] On remand, the NYSE concluded that the three-month suspension was remedial and therefore in the public interest, and that the censure and fine were warranted. O'Callaghan now appeals the NYSE's remand decision. We base our findings on an independent review of the record.

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[1] 15 U.S.C. § 78k(a); 17 C.F.R. § 240.11a-1. Section 11(a) and Rule 11a-1, with certain exceptions not relevant here, make it unlawful for a floor broker to trade for an account in which the broker has an interest or over which the broker exercises investment discretion. These provisions are designed to prevent floor brokers from exploiting short-term trading information and opportunities not available to persons who are not on the floor and members of the general public. *D'Alessio v. SEC*, 380 F.3d 112, 113-14 (2d Cir. 2004).

[2] *See* NYSE Rules 90(a) & 95(a) (prohibiting floor brokers from engaging in proprietary and discretionary trading); NYSE Rule 476(a)(6) (prohibiting conduct inconsistent with just and equitable principles of trade).

[3] *James Gerard O'Callaghan*, Securities Exchange Act Rel. No. 57840 (May 20, 2008), 93 SEC Docket 6067, 6078, 6083-84.

II.

A. Facts

For purposes of this appeal, the facts are not at issue because we previously made findings of fact in the May 20, 2008 Opinion.[4] However, certain facts are relevant to the disposition of the remand appeal, and a brief summary therefore appears below.

O'Callaghan entered the securities industry in 1969, became a member of the NYSE in 1973, and has been employed on the floor of the Exchange for more than thirty years. In 1997, O'Callaghan formed an independent floor brokerage firm, which he operated as a sole proprietorship until 2003, when he converted the firm to a limited liability company. As an independent floor broker, O'Callaghan primarily executed orders initiated through other NYSE members. O'Callaghan admits that he knew during the period at issue that the on-floor trading rules prohibited floor brokers from initiating and executing the same trades on the Exchange floor, and that his firm's compliance manual made it clear that such trading was improper.

O'Callaghan had investment discretion over an account that was maintained at Wall Street Discount Corporation ("Wall Street Discount"), an "upstairs," or off-the-floor, member organization. The account belonged to LDL Trading, Inc. ("LDL account"), a New Jersey corporation, and traded securities for the benefit of Patrick Zente, O'Callaghan's father-in-law, and members of Zente's family. O'Callaghan started executing trades for the LDL account in 2000 to save Zente money on the commissions charged by floor brokers.

Zente did not place any orders for the LDL account. O'Callaghan or Frank Ali, O'Callaghan's chief clerk and compliance officer at the time, regularly transmitted reports of trade executions for the LDL account to Wall Street Discount without first receiving any orders from Zente.[5] Upon receiving those reports, Wall Street Discount completed order tickets to memorialize those trades and credit them to the LDL account. Wall Street Discount never sent any customer orders to O'Callaghan for execution.

During the relevant period, Wall Street Discount's practice was to time-stamp an upstairs order ticket twice, first on the left-hand side when it received a customer order to buy or sell stock, and then on the right-hand side when it received a report of execution of the order. At that

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[4] O'Callaghan states in his opening brief that he does not contest in this appeal the Commission's "earlier findings relating to [his] liability," but, because he disputes the facts and believes that he committed no violations, he "reserves the right to challenge such findings in a judicial forum on final determination by the Commission."

[5] Ali was charged as a co-respondent in this proceeding and consented to a five-year bar in a compliance or a supervisory capacity. *Frank Joseph Ali*, New York Stock Exchange Hearing Panel Decision 05-4 (Jan. 13, 2005), http://www.nyse.com/pdfs/05-004/.pdf.

time, it took at least five minutes to execute a trade. As a result, there usually was a several minute gap between the first and second time-stamps. However, when O'Callaghan or Ali called Wall Street Discount to report the execution of a trade for which Wall Street Discount had not received any customer order, the upstairs order ticket had "double time-stamps," meaning there were two time-stamps only seconds apart.

An NYSE investigator analyzed a sample of 159 LDL trades (from more than 700), using O'Callaghan's floor tickets, Wall Street Discount's order tickets, and NYSE reports showing the times of O'Callaghan's trade executions as captured by the NYSE's systems. The analysis revealed that O'Callaghan's floor booth tickets were almost always time-stamped before the first time-stamps on Wall Street Discount's order tickets, indicating that the trades originated on the Exchange floor. Moreover, nearly every execution time written on O'Callaghan's floor tickets preceded the upstairs time-stamps, further indicating that the trades originated on the floor. In addition, many of Wall Street Discount's order tickets had "double time-stamps," indicating that O'Callaghan originated and executed the same trades for the LDL account.

In March 2001, the NYSE commenced an investigation of O'Callaghan's floor trading after it triggered alerts in the Exchange's surveillance systems. In October 2001, the NYSE notified O'Callaghan of its investigation. O'Callaghan stopped trading for the LDL account around this time.

B. Procedural History

1. NYSE Original Decision

On November 2, 2005, the NYSE found that, between December 2000 and October 2001, while on the floor of the Exchange, O'Callaghan violated Exchange Act Section 11(a), Exchange Act Rule 11a-1(a), and NYSE Rules 90(a), 95(a), and 476(a)(6), by initiating and executing trades for an account over which he had investment discretion. The NYSE found O'Callaghan's hearing testimony that he did not initiate and execute orders on behalf of the LDL account to be "lacking in credibility" and "not supported by other testimony or documentary evidence." The NYSE censured O'Callaghan, fined him $30,000, and suspended him for three months from membership, allied membership, approved person status, and from employment or association in any capacity with any member or member organization. On June 6, 2007, the NYSE's Board of Directors affirmed the decision.

2. Commission Opinion Remanding to the NYSE

O'Callaghan appealed to the Commission. In the May 20, 2008 Opinion, we sustained the Exchange's findings of violation but remanded the proceeding for a reconsideration of the sanctions imposed.[6] The remand directed the NYSE to articulate the protective interests to be served by removing O'Callaghan from the floor consistent with *McCarthy v. SEC*,[7] a Second Circuit Court of Appeals decision. We noted that the Exchange had stated:

> Respondent is a $2 broker, not a specialist or a broker for a large wire house. If Respondent is not there to service his clients, they will find new brokers to handle their trades. A specialist or wire house broker could easily have a job to come back to after three months. Respondent will likely have to rebuild his business. *The financial and business impact on a $2 broker of a three-month suspension has the potential to be catastrophic and terminal.* This represents a serious deterrent to other similarly situated brokers. (Emphasis supplied.)

We remanded all of the sanctions, instructing the NYSE to "address the protective interests to be served by removing O'Callaghan from the floor, the mitigating factors presented in the record, and any other factors related to whether a suspension is appropriately remedial and not punitive."

3. NYSE Remand Decision

On remand, the NYSE hearing panel explained that its original finding that the suspension could have a "catastrophic and terminal" effect was not intended "to deliberately or effectively terminate [O'Callaghan's] business." The NYSE determined that O'Callaghan's actions "were repeated over a period of approximately ten months," "constituted a deliberate pattern of behavior, not an isolated incident or momentary lapse in judgment," and "undermined trust in the integrity of the market, which can only function properly if participants operate according to specific rules and expectations." The NYSE found that O'Callaghan acted on his own accord, was not a minor participant – unlike the court's finding in *McCarthy*, and involved his clerk in the misconduct. The NYSE also found that "the rules which [he] violated were clear-cut and required no subsequent clarification," in contrast to the ambiguity surrounding the rules violated in *McCarthy*.

The NYSE acknowledged that it originally considered the degree of harm to be a mitigating factor but found that there is "harm to the integrity of the marketplace whenever a rule is broken" as a result of the time and place advantage acquired from the misconduct. The NYSE found that the potential gain to O'Callaghan was minimal, given that he did not take fees for

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6 *O'Callaghan*, 93 SEC Docket at 6078, 6083-84.

7 406 F.3d 179, 188-89, 190 (2d Cir. 2005).

himself and did no more than favor a family member and obtain goodwill.[8] The NYSE found that O'Callaghan continued to work on the Exchange floor. It also found that there are no measures in place to prevent him from engaging in similar misconduct, noting that he is now his firm's compliance officer.

The NYSE concluded that a three-month suspension, censure, and $30,000 fine were "necessary to impress upon [O'Callaghan] the seriousness of his conduct and deter him from similar future misconduct." The NYSE Board of Directors affirmed the decision, and O'Callaghan filed an appeal with the Commission on February 11, 2009.

4. July 29, 2009 Suspension

On February 20, 2009, shortly after O'Callaghan filed his petition for review, we granted his request for a stay of the suspension pending this appeal. However, we denied his request for a stay of the censure and fine on the grounds that he neither addressed the merits of staying those sanctions in his motion nor provided any basis for concluding that a stay would serve the public interest.[9] The Central Registration Depository indicates that O'Callaghan subsequently filed a Form U5 for "full termination" of his securities industry registrations and a Form BDW for "full withdrawal" of his firm's broker-dealer registration, both filings effective as of May 18, 2009. O'Callaghan failed to pay the fine, which resulted in the imposition of a suspension by the NYSE effective July 29, 2009 and continuing until the fine is paid.[10] On August 10, 2009, we issued an order directing additional briefing by the parties regarding the question of whether the suspension has any impact on the merits of this proceeding. To date, O'Callaghan has served approximately four months of his suspension for failure to pay the fine.

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[8] O'Callaghan had been the subject of subsequent disciplinary action, in which he consented to findings regarding net capital and failure to supervise violations, a censure, a $75,000 fine, and an undertaking. The NYSE, however, found this subsequent disciplinary action was not an aggravating factor, particularly because "Enforcement had an opportunity to take the current matter into consideration when negotiating an appropriate penalty with [O'Callaghan] in the subsequent action."

[9] *Order Granting Partial Stay by Delegated Authority* (Feb. 20, 2009) (granting stay of suspension but denying stay of censure and fine).

[10] *See* FINRA Rule 8320 (stating that FINRA may summarily suspend or expel from membership a member that fails to pay promptly a fine imposed pursuant to Rule 8310 when such fine becomes due and payable).

III.

Section 19(e)(2) of the Securities Exchange Act of 1934 governs our consideration of O'Callaghan's appeal from the NYSE's decision on remand.[11] Section 19(e)(2) provides that the Commission will sustain the Exchange'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.[12]

We directed the NYSE to address the protective interests to be served by removing O'Callaghan from the floor consistent with the Second Circuit's opinion in *McCarthy*. We did so based on our concern that the sanction appeared to be punitive rather than remedial, given the NYSE's comments about the potential impact of a three-month suspension on O'Callaghan's business.

On remand, the NYSE clarified that the suspension was "meant to encompass small brokerage firms generally," and that the NYSE carefully calibrated the length of the suspension to deter O'Callaghan from future misconduct, not destroy his business. O'Callaghan argues that the remand decision fails to explain adequately the remedial purpose to be served by the suspension in light of its potentially destructive effect on his business. He argues that the suspension must be vacated because it is punitive. He further asserts that the suspension, based on his failure to pay the fine, "has no impact on the merits of this proceeding" because, among other things, "the fine and the three-month suspension are based on the same order and reversal of the fine will vacate the fine suspension."[13]

O'Callaghan voluntarily terminated his individual registrations and the registration of his firm. O'Callaghan also failed to pay the fine imposed by the NYSE in this proceeding.[14] As a result the NYSE suspended him on July 29, 2009. O'Callaghan has placed himself in that position as a consequence of his decision to terminate his registrations and not to pay the fine. The harm O'Callaghan asserts he might suffer from being off the floor and having to rebuild his business results from his own actions.

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11 15 U.S.C. § 78s(e)(2).

12 O'Callaghan does not claim, and the record does not show, that NYSE's action imposed an unnecessary or inappropriate burden on competition.

13 The NYSE stated in its brief that "O'Callaghan's failure to pay the fine further enforces the fact that a serious sanction is necessary."

14 We denied O'Callaghan's request for a stay of the fine pending resolution of this appeal. *See supra* Section II.B.4.

We believe the NYSE's sanctions at issue here are neither excessive nor oppressive. The record supports the NYSE's conclusion that O'Callaghan committed a serious offense. O'Callaghan's actions, as noted by the NYSE, occurred repeatedly for ten months, ceased only when he learned about the pending investigation, and evidenced a deliberate pattern of behavior. O'Callaghan acted on his own accord, was not a minor participant – unlike the court's finding in *McCarthy*, and involved his clerk in the misconduct. The rules that O'Callaghan violated presented little or no ambiguity in contrast to the asserted ambiguity surrounding the rules that were violated in *McCarthy*. Indeed, O'Callaghan admits that he knew during the period at issue that the on-floor trading rules prohibited floor brokers from initiating and executing the same trades on the Exchange floor, and that his firm's compliance manual made it clear that such trading was improper. The rules at issue protect investors by preventing floor brokers from exploiting short-term trading information and opportunities not available to persons who are not on the floor and members of the general public.

O'Callaghan argues that there is no potential for repetition. He cites two Commission releases to support his argument that "the NYSE has installed very detailed electronic reporting systems," which, he claims, "preclude originating and trading an order on the floor."[15] Those releases, however, acknowledge that technological advances have diminished, but not eradicated, the time and place advantages available to floor brokers. Moreover, the releases did not repeal the NYSE rules prohibiting initiating and executing an order on the floor. We believe that O'Callaghan's failure to accept responsibility and to recognize the wrongfulness of his conduct suggests a troubling lack of appreciation for the responsibilities of a securities professional that further indicates a potential for repetition, particularly given that he is now his firm's compliance officer.[16]

O'Callaghan also claims that the "mere passage of time" since 2001 without engaging in similar conduct is mitigating under *McCarthy*. In 2008, O'Callaghan settled a disciplinary action with respect to net capital and failure to supervise violations. While the NYSE declined to find that this settlement was an aggravating factor, it observed that "the existence of the disciplin[ary action] refutes Respondent's claim of a clean record." As the NYSE noted, even putting aside

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[15] *See Notice of Filing and Order Granting Accelerated Approval to Create a New NYSE Market Model*, Exchange Act Rel. No. 58845 (Oct. 24, 2008), 94 SEC Docket 11063; *Notice of Filing to Create a New NYSE Market Model*, Exchange Act Rel. No. 58184 (July 17, 2008), 93 SEC Docket 7869.

[16] *John S. Brownson*, 55 S.E.C. 1023, 1030 (2002) (finding respondent's unwillingness to accept responsibility for his actions "suggests a troubling lack of appreciation for the responsibilities of a securities professional").

O'Callaghan's subsequent record, the *McCarthy* court stated that the absence of further violations does not necessarily entitle a trader, such as O'Callaghan, to a reversal.[17]

O'Callaghan claims that he "felt unfettered in his challenged conduct [*i.e.*, the violations at issue] because he believed that an earlier investigation into something similar – which closed with no action taken – vindicated him," and that "[u]ncertainty that conduct is violative is itself a mitigating factor." However, O'Callaghan admits that he knew during the period at issue that the on-floor trading rules prohibited floor brokers from initiating and executing the same trades on the Exchange floor, and that his firm's compliance manual made it clear that such trading was improper. If O'Callaghan was uncertain about the propriety of his conduct, it was his duty to determine whether his conduct complied with the securities laws.[18] O'Callaghan does not claim that he made any effort to determine whether his conduct was appropriate.

In considering the mitigating factors raised by O'Callaghan, the NYSE found that O'Callaghan's misconduct resulted in "little or no harm" and that O'Callaghan received no personal financial gain.[19] The NYSE concluded that a three-month suspension, in contrast to the three-year suspension sought by NYSE's Division of Enforcement, appropriately accounted for those mitigating circumstances.

We conclude that the sanctions – a censure, which O'Callaghan concedes is appropriate, fine, and suspension – serve the public interest. We agree with the NYSE that the combination of sanctions serves to stress the importance of those rules and deter O'Callaghan and others from engaging in similar misconduct in the future.[20]

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[17] *See McCarthy*, 406 F.3d at 191 (stating that the court did "not hold that when a trader's suspension is stayed pending appeal, he is entitled to a reversal of that suspension if he engages in no further violations during the period of the stay").

[18] *Cf. Jason A. Craig*, Exchange Act Rel. No. 59137 (Dec. 22, 2008), 94 SEC Docket 12694, 12700 & n.22 (finding that applicant's uncertainty about his disclosure on Form U4 imposed a duty to determine the form's accuracy) (citing *James Alan Schneider*, 52 S.E.C. 840, 843 (1996) (holding applicant responsible for accuracy of Form U4's contents), *aff'd*, 118 F.3d 1577 (3d Cir. 1997)).

[19] In the remand decision, the NYSE acknowledged the degree of harm was a mitigating factor, but also stated that "there is harm to the integrity of the marketplace whenever a rule is broken." The NYSE further stated that, although it originally found that O'Callaghan received no personal financial gain, "[f]avoring a family member constitutes a form of gain, even if it cannot be quantified."

[20] *See Robert E. Strong*, Exchange Act Rel. No. 57426 (Mar. 4, 2008), 92 SEC Docket 2875, 2895 (finding that a fine serves the public interest by encouraging future

(continued...)

O'Callaghan argues that the NYSE denied him a "fair procedure" when it rejected his request for an evidentiary hearing on remand. O'Callaghan had two full evidentiary hearings below – one for the violations at issue and another for the sanctions – at which both parties introduced evidence and where O'Callaghan cross-examined the NYSE's witnesses, called his own witnesses, and testified on his own behalf. He also had the opportunity on remand to file briefs with the NYSE and the Commission. O'Callaghan fails to specify what additional facts he would adduce that would warrant further evidentiary hearings.[21] Accordingly, we find no merit to O'Callaghan's argument that the NYSE denied him a "fair procedure."

On this record, we find that the sanctions are remedial and are neither excessive nor oppressive.

An appropriate order will issue.[22]

By the Commission (Chairman SCHAPIRO and Commissioners CASEY, WALTER, AGUILAR and PAREDES).

Elizabeth M. Murphy
Secretary

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

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[20] (...continued)
compliance with the rules at issue by the applicant and others with similar responsibilities); *see also SEC v. Palmisano*, 135 F.3d 860, 866 (2d Cir. 1998) (noting that the deterrent effect of a fine serves important nonpunitive goals, such as "encouraging investor confidence, increasing the efficiency of financial markets, and promoting the stability of the securities industry"). A fine is normally imposed as a deterrent against future misconduct, and its amount need not be related to the amount of an applicant's wrongful gain. *See Patten Sec. Corp.*, 51 S.E.C. 568, 579 (1993). The NYSE found that the amount of the fine represents a portion of the account's (*i.e.*, his father-in-law's) profits that he generated through his misconduct.

[21] The issues for which O'Callaghan seeks to present additional factual evidence are either moot (*i.e.*, the effect of a three-month suspension) or are not in dispute (*i.e.*, minimal harm to the trading public and personal gain, and NYSE electronic safeguards).

[22] 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. 61134 / December 10, 2009

Admin. Proc. File No. 3-12668

In the Matter of the Application of

JAMES GERARD O'CALLAGHAN
c/o Andrew J. Goodman
James H. Freeman
Garvey Schubert Barer
100 Wall Street, 20th Floor
New York, NY 10005

For Review of Disciplinary Action Taken by

NYSE Regulation, Inc.

ORDER SUSTAINING DISCIPLINARY ACTION

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

ORDERED that the disciplinary action by NYSE against James Gerard O'Callaghan be, and it hereby is, sustained.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61136; File No. SR-CBOE-2009-022)

December 10, 2009

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1, to List and Trade S&P 500 Dividend Index Options

I. Introduction

On March 25, 2009, 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 proposed rule change to list and trade cash-settled options that overlie the S&P 500 Dividend Index. The proposed rule change was published for comment in the Federal Register on April 6, 2009.[3] On May 4, 2009, the Commission received one comment on the proposal.[4] On May 19, 2009, the Exchange responded to the comment letter[5] and filed Amendment No. 1 to the proposed rule change. The Commission is publishing this notice to solicit comments on the proposed rule change, as modified by Amendment No. 1, and simultaneously is approving the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 59667 (March 31, 2009), 74 FR 15528 ("Notice").

4 See email from Julian E. Hammar, Assistant General Counsel, Commodity Futures Trading Commission ("CFTC"), to James Eastman, Chief Counsel and Associate Director, and Elizabeth King, Associate Director, Division of Trading and Markets, Commission, dated May 4, 2009 ("CFTC Comment Letter").

5 See letter from Jenny L. Klebes, Senior Attorney, CBOE, to Elizabeth M. Murphy, Secretary, Commission, dated May 19, 2009.

II. Description of the Proposal

CBOE proposes to list and trade cash-settled, European-style options that overlie the S&P 500 Dividend Index.

Index Design

The S&P 500 Dividend Index represents the accumulated ex-dividend amounts of all S&P 500 Index component securities over a specified accrual period. Each day Standard & Poor's calculates the aggregate daily dividend totals for the S&P 500 Index component securities, which are summed over any given calendar quarter and are the basis of the S&P 500 Dividend Index. On any given day, the index dividend is calculated as the total dividend value for all constituents of the S&P 500 Index divided by the S&P 500 Index divisor. The total dividend value is calculated as the sum of dividends per share multiplied by the shares outstanding for all constituents of the S&P 500 Index that are trading "ex-dividend" on that day.

The Exchange will set the accrual period for S&P 500 Dividend Index options at listing (*e.g.*, quarterly, semi-annually, annually), which will be reset to zero at the end of the specified accrual period.[6] A One-Year S&P 500 Dividend Index will be expressed in S&P 500 Index points and will reset to zero at the end of each annual accrual period.[7]

The S&P 500 Dividend Index is currently calculated by Standard & Poor's and is disseminated by Standard and Poor's once per day.[8] The S&P 500 Dividend Index is reported in

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6 See Amendment No. 1. In its original proposal, CBOE described that the S&P 500 Dividend Index represents the accumulated ex-dividend amounts of all S&P 500 Index (dividend paying) component securities over a specified quarterly accrual period and that the index is reset to zero at the end of each quarterly accrual period.

7 Standard & Poor's has not committed to creating a One-Year S&P 500 Dividend Index. In the event that S&P does not calculate the index, the Exchange plans to calculate an annual index from published values of the quarterly S&P 500 Dividend Index.

8 The daily values can be accessed on Bloomberg under the symbol: SPXDIV <Index>.

absolute numbers (e.g., 3, 5, 7), and the Exchange proposes to trade option contracts on the S&P 500 Dividend Index level with an applied scaling factor of 10.[9] Once daily, CBOE will disseminate the underlying S&P 500 Dividend Index value with the applied scaling factor of 10 through the Options Price Reporting Authority ("OPRA") and/or one or more major market data vendors.

Options Trading

The exercise-settlement value for S&P 500 Dividend Index options will be the S&P 500 Dividend Index that is calculated by Standard & Poor's with an applied scaling factor. The underlying S&P Dividend Index will be quoted in decimals and one point will be equal to $100.[10] The minimum tick size for options trading at or below 3.00 will be 0.05 point ($5.00) and for all other series, it will be 0.10 ($10.00).

The Exchange proposes to list series at 1 point ($1.00) or greater strike price intervals if the strike price is equal to or less than 200 scaled index points on S&P 500 Dividend Index options. When the strike price exceeds 200 scaled index points, strike price intervals will be no less than 2.5 points.

Initially, the Exchange will list in-, at- and out-of-the-money strike prices and may open for trading up to five series above and five series below the calculated forward value of the S&P 500 Dividend Index, which is the anticipated value of the S&P 500 Dividend Index at the end of the specified accrual period.[11] In addition, either in response to customer demand or as

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9 For example, where the S&P 500 Dividend Index is 3, the underlying will have an index value of 30 (3 x 10).

10 The contract multiplier will be $100.

11 See Amendment No. 1. In its original proposal, CBOE proposed to use the related S&P 500 Dividend Index futures price as the level for setting strikes. Because no related futures contract is currently trading, CBOE now proposes to use the calculated forward value of the S&P 500 Dividend Index. The Exchange states that the calculated forward

calculated forward value of the S&P 500 Dividend Index moves from the initial exercise prices of options and LEAPs series that have been opened for trading, the Exchange may open for trading up to an additional twenty series. The Exchange will not be permitted to open for trading series with 1 point ($1.00) intervals within 0.50 of an existing 2.5 point ($2.50) strike price with the same expiration month. The Exchange will not be permitted to list LEAPS on S&P 500 Dividend Index options at intervals less than 1 point.

The Exchange also proposes to add new Interpretation and Policy .13 to Rule 5.5, Series of Option Contracts Open for Trading, which will be an internal cross reference stating that the intervals between strike prices for S&P 500 Dividend Index option series will be determined in accordance with proposed new Interpretation and Policy .01(h) to Rule 24.9.

Exercise and Settlement

The proposed options will expire on the Saturday following the third Friday of the expiring month. Trading in the expiring contract month will normally cease at 3:15 p.m. Chicago time on the last day of trading (ordinarily the Thursday before expiration Saturday, unless there is an intervening holiday). When the last trading day is moved because of an Exchange holiday (such as when CBOE is closed on the Friday before expiration), the last trading day for expiring options will be Wednesday.

Exercise will result in delivery of cash on the business day following expiration. S&P 500 Dividend Index options will be A.M.-settled. The exercise-settlement amount will be equal to the difference between the exercise-settlement value and the exercise price of the option, multiplied by the contract multiplier ($100).

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value of the S&P 500 Dividend Index is a market derived estimate based on things such as: (1) the historical dividend policy of the components stocks on the S&P 500 Index, (2) the anticipated date of dividend payment, and (3) the expected start or increase of a dividend payment or the expected elimination or decrease of a dividend payment.

If the exercise settlement value is not available or the normal settlement procedure cannot be utilized due to a trading disruption or other unusual circumstance, the settlement value will be determined in accordance with the rules and bylaws of the OCC.

Surveillance

The Exchange states that it will use the same surveillance procedures currently utilized for each of the Exchange's other index options to monitor trading in S&P 500 Dividend Index options. The Exchange further represents that these surveillance procedures shall be adequate to monitor trading in options on these option products. For surveillance purposes, the Exchange will have complete access to information regarding trading activity in the securities the accumulated ex-dividend amounts of which are represented by the S&P 500 Dividend Index (i.e., S&P 500 Index component securities).

Position Limits

The Exchange is not proposing to establish any position limits for S&P 500 Dividend Index options. Because the S&P 500 Dividend Index represents the accumulated "ex-dividend" amounts of all S&P 500 Index component securities, the Exchange believes that the position and exercise limits for these new products should be the same as those for broad-based index options, e.g., SPX, for which there are no position limits. S&P 500 Dividend Index options will be subject to the same reporting and other requirements triggered for other options dealt in on the Exchange.[12]

Exchange Rules Applicable

Except as modified in this proposed rule change, the rules in Chapters I through XIX, XXIV, XXIVA, and XXIVB will equally apply to S&P 500 Dividend Index options.

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12 See Rule 4.13, Reports Related to Position Limits.

S&P 500 Dividend Index options will be margined as "broad-based index" options, and under CBOE rules, especially, Rule 12.3(c)(5)(A), the margin requirement for a short put or call shall be 100% of the current market value of the contract plus up to 15% of the aggregate contract value. Additional margin may be required pursuant to Exchange Rule 12.10.

The Exchange proposed to designate S&P 500 Dividend Index options as eligible for trading as Flexible Exchange Options as provided for in Chapters XXIVA (Flexible Exchange Options) and XXIVB (FLEX Hybrid Trading System).

Capacity

CBOE represents that it believes the Exchange and OPRA have the necessary systems capacity to handle the additional traffic associated with the listing of new series that will result from the introduction of S&P 500 Dividend Index options.

III. Summary of Comments

The CFTC Comment Letter raised several concerns the CFTC staff has regarding the proposed rule change. First, the CFTC staff questioned whether the S&P 500 Dividend Index is an index composed of securities. Specifically, the CFTC staff asserted that a securities index is traditionally based on a weighted average of constituent stock prices, while the S&P 500 Dividend Index represents accrued dividend amounts. As such, the CFTC staff suggested that the S&P 500 Dividend Index may be more akin to an event contract than to a securities index.

The Exchange disagrees with the CFTC staff's comment. The CBOE notes that the S&P 500 Dividend Index measures stock price changes of S&P 500 Index component securities on their respective ex-dividend dates. In addition, as described by the Exchange, the S&P 500 Dividend Index is calculated using the ex-dividend amount of the same set of component securities, same shares outstanding, same capitalization weighting methodology and the same index divisor that is used to calculate the S&P 500 Index. Based on these factors, the Exchange concluded that its proposed product is an option based on a security "including any interest therein or based on the value thereof" as defined under §2(a)(1) of the Securities Act of 1933 and §3(a)(10) of the Act.

Second, the CFTC staff noted that while CBOE's proposal provides that the Exchange will list strike prices based on the related S&P 500 Dividend Index futures contract, no such futures contract currently exists. In Amendment No. 1, the Exchange modified its methodology for setting strike prices. As discussed above, rather than basing strike prices on the S&P 500 Dividend Index futures contract, which does not exist, the Exchange proposes to use the calculated forward value of the S&P 500 Dividend Index at the end of the specified accrual period as the measure for setting strikes.

Finally, the CFTC Comment Letter expressed a concern regarding the Exchange's surveillance of the proposed product for manipulation. In particular, the CFTC staff questioned the Exchange's assertion that it will have access to information regarding trading in the underlying securities, stating that the S&P 500 Dividend Index represents accrued dividends, which are determined by the boards of directors of the constituent securities. In response, the Exchange represented that it has adequate tools in place, such as large options positions reports to surveil for market manipulation and will continue to use the same surveillance procedures currently utilized for each of the Exchange's other index options to monitor trading in S&P 500 Dividend Index options. In addition, the CBOE noted that it shares its specific surveillance procedures with the Commission and that as a member of the Intermarket Surveillance Group ("ISG"), the Exchange is able to obtain information from the exchanges listing the issuers in the S&P 500 Dividend Index pertaining to specific issuers. The Exchange may also obtain from the exchanges and FINRA, the necessary information pertaining to trading in the stock comprising the index.

IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[13] Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,[14] which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. The Commission believes that CBOE's proposal gives options investors the ability to make an additional investment choice in a manner consistent with the requirements of Section 6(b)(5) of the Act.[15]

As a threshold matter, the Commission finds that the S&P 500 Dividend Index Options proposed by CBOE are securities. Section 3(a)(10) of the Act[16] defines security to include, in part, "any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof)."[17] As the

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13 In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

14 15 U.S.C. 78f(b)(5).

15 15 U.S.C. 78f(b)(5).

16 15 U.S.C. 78c(a)(10).

17 In determining whether a derivative is a security, the Commission and the courts have looked to the economic reality of the product. See Caiola v. Citibank, N.A., New York, 295 F.3d 312, 325 (2d Cir. 2002), quoting United Housing Foundation v. Foreman, 421 U.S. 837, 848 (1975) ("In searching for the meaning and scope of the word 'security' . . . the emphasis should be on economic reality"). Construing the definition of a security in this manner permits the Commission and the courts "sufficient flexibility to ensure that

Commission has previously noted, "[t]he concept of an 'interest in' a security plainly includes rights generating a pecuniary interest in a security, such as the right to a <u>dividend payout</u> or bond (coupon) payment."[18] Accordingly, options on the value of dividends declared by the issuers of component securities of a group or index of securities are options on an interest in, or based on the value of an interest in, that group or index of securities.

The S&P 500 Dividend Index Option is a cash-settled option based on the value of the dividends of the S&P 500 securities.

If a dividend is declared by the issuer of a component security of the S&P 500 Index, the value of the S&P 500 Dividend Index increases. Upon expiration of an option, a buyer of a call option on the S&P 500 Dividend Index will receive (and the seller of the call option will pay) cash equal to the difference between the value of the index and the strike price of the option, if the index value exceeds the strike price of the option. If the value of the index exceeds the strike price of the option, the option seller makes a payment and the option buyer receives a payment. In other words, the S&P 500 Dividend Index Option payout is based on the dividends paid by issuers of the component securities of the S&P 500 Index.

The value of the dividends of the securities composing the S&P 500 Index is calculated based on price changes of such securities resulting solely from the distribution of ordinary cash dividends, multiplied by the number of float adjusted shares outstanding and divided by the S&P 500 Index divisor.

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those who market investments are not able to escape the coverage of the Securities Acts by creating new instruments that would not be covered by a more determinate definition." <u>Reves v. Ernst & Young, 494</u> U.S. 56, 63 n.2 (1990).

18 Exchange Act Release No. 55781 (June 6, 2007), 72 FR 32372, 32376 (June 12, 2007) (emphasis added).

The Commission understands that, prior to its "ex-dividend" date, the component security's price reflects the right to receive the dividend amount declared by the issuing company. As of the ex-dividend date, the component security trades without the right to receive that dividend payment. The component security's listing exchange makes internal price adjustments and notifies data vendors and other parties of the per share amount of the dividend for informational purposes, in order to ensure that the reported "net change" from the previous closing price excludes the drop in share value that results from the dividend payment.

The Commission understands that, as it pertains to the S&P 500 Dividend Index, such price adjustments will be equal to the amount of the component securities' ordinary cash dividends. Therefore, the S&P 500 Dividend Index Options are, in effect, options on the accumulated ex-dividend adjustments to the prices of the weighted index component securities.

For these reasons, the Commission finds that S&P 500 Dividend Index Options are options on interests in, or based on the value of interests in, a group or index of securities and, therefore, are securities under Section 3(a)(10) of the Act.[19]

Further, the Commission believes that the listing rules proposed by CBOE for S&P 500 Dividend Index options are reasonable and consistent with the Act. The S&P 500 Dividend Index Options will provide a mechanism for purchasers to hedge their exposure to changes in the dividend payment policies of issuers of securities that compose the S&P 500 Dividend Index.

The Commission believes that permitting $1.00 strike price intervals for S&P 500 Dividend Index options if the strike price is equal to or less than 200 scaled index points will provide investors with added flexibility in the trading of these options and further the public interest by allowing investors to establish positions that are better tailored to meet their

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19 15 U.S.C. 78c(a)(10).

investment objectives. As explained by CBOE, the S&P 500 Dividend Index will fluctuate around a limited index value range, and therefore the implementation of $1 strike price intervals is designed to better serve investors by providing greater flexibility. Because of this unique characteristic, the Commission believes that the implementation of $1 strike price intervals for S&P 500 Dividend Index options, within the parameters of the rule, is appropriate. The Commission also notes that CBOE's proposed use of the calculated forward value of the S&P 500 Dividend Index for purposes of adding strike price intervals is a methodology reasonably designed to reflect the unique properties of the index (in particular, that the current index level is reset to zero at the end of each accrual period).

The Commission also finds that the Exchange's proposal to set the accrual period for S&P 500 Dividend Index options at the time of listing is reasonable and consistent with the Act. The Commission believes that this will provide the Exchange flexibility in designing the product to meet the needs of market participants to hedge their exposure to changes in dividend payments of S&P 500 Index stocks.

The Commission notes that the S&P 500 Dividend Index is currently calculated and disseminated by Standard and Poor's once per day. Further, CBOE will disseminate the underlying S&P 500 Dividend Index value with the applied scaling factor of 10 through OPRA and/or one or more major market data vendors once daily.

The Exchange has proposed to establish no position or exercise limits for S&P 500 Dividend Index options and to require the same margin as for broad-based index options.[20] The

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20 The Exchange's decision to apply its broad-based index option position and exercise limits and margin requirements to these new products is unrelated to whether the S&P 500 Dividend Index is a narrow-based security index under Section 3(a)(55) of the Exchange Act.

Commission believes that CBOE's proposed rules relating to position limits, exercise limits, and margin requirements are appropriate.

The Commission also believes that the Exchange's proposal to allow S&P 500 Dividend Index options to be eligible for trading as FLEX options is consistent with the Act. The Commission previously approved rules relating to the listing and trading of FLEX Options on CBOE, which gives investors and other market participants the ability to individually tailor, within specified limits, certain terms of those options.[21] The current proposal incorporates S&P 500 Dividend Index options that trade as FLEX Options into these existing rules and regulatory framework.

The Commission notes that CBOE represented that it had an adequate surveillance program to monitor trading of S&P 500 Dividend Index options and intends to apply its existing surveillance program to support the trading of these options. As with other securities, there is a potential risk that a corporate insider may exploit his or her advance knowledge of changes to an issuer's dividend policy through the purchase or sale of an S&P 500 Dividend Index Option. In recent years, the Commission has taken a number of enforcement actions in cases where insiders executed securities transactions to exploit their knowledge of changes in issuers' dividend policies.[22] Accordingly, adequate surveillance is an important responsibility of the CBOE. The

21 See Securities Exchange Act Release No. 31910 (February 23, 1993), 58 FR 12056 (March 2, 1993).

22 See, e.g., SEC v. David L. Johnson, Civil Action No. 05-CV-4789 (USDC E.D. Pa.) (Sept. 7, 2005) (consent to permanent injunction, disgorgement and civil penalty for a person who allegedly sold shares of an issuer based on inside information of a dividend cut, and tipped his son to do likewise); SEC v. Barry Hertz, Civil Action No. 05-2848 (USDC E.D.N.Y.) (Mar. 16, 2007) (consent to final judgment, including an injunction and two-year bar from serving as an officer or director of a public corporation, for a person alleged to have traded on inside information, including purchasing shares of an issuer while in possession of positive news of a first time dividend issuance).

CFTC Comment Letter took issue with this representation, questioning CBOE's ability to adequately surveil for manipulation in S&P 500 Dividend Index options. In its response, the Exchange stated that its access to information provided by the ISG, coupled with its tools such as large options positions reports prove more than sufficient for surveillance of market manipulation, particularly given that the very broad composition of the S&P 500 Dividend Index would render manipulation of options on the index to be extremely difficult. The Commission agrees with CBOE that it should have the ability and resources to adequately surveil for manipulation in S&P 500 Dividend Index options.

In approving the proposed rule change, the Commission has also relied upon the Exchange's representation that it has the necessary systems capacity to support new options series that will result from this proposal.

The Commission finds good cause for approving this proposed rule change, as modified by Amendment No.1, prior to the thirtieth day after publishing notice of Amendment No. 1 in the Federal Register. In Amendment No. 1, the Exchange: (i) revised the methodology for setting strike prices so that strike prices will no longer be based on a futures product value but rather on the calculated forward value of the S&P 500 Dividend Index, and (ii) determined that the accrual period for the S&P 500 Dividend Index options will be set at listing and could be quarterly, semi-annually, annually, etc. to provide investors and other market participants with a more flexible product to hedge their exposure to changes in dividend payments (either up or down) of S&P 500 Index stocks. Thus, the Commission believes that it is appropriate to allow CBOE to immediately list and trade options on the S&P 500 Dividend Index, providing investors with additional means to manage their risk exposure and carry out their investment objectives.

Accordingly, the Commission finds good cause, consistent with Section 19(b)(2) of the Act,[23] to approve the proposal, as modified by Amendment No. 1, on an accelerated basis.

V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 1, including whether Amendment No. 1 is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2009-022 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-CBOE-2009-022. 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, on official

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23 15 U.S.C. 78s(b)(2).

business days between the hours of 10:00 am and 3:00 pm. Copies of the 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-CBOE-2009-022 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[24] that the proposed rule change (SR-CBOE-2009-022), as modified by Amendment No. 1, be, and hereby is, approved on an accelerated basis.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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[24] 15 U.S.C. 78s(b)(2).

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES ACT OF 1933
Rel. No. 9085 / December 11, 2009

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 61153 / December 11, 2009

Admin. Proc. File No. 3-12829

In the Matter of

GUY P. RIORDAN

OPINION OF THE COMMISSION

BROKER-DEALER PROCEEDING

CEASE-AND-DESIST PROCEEDING

Grounds for Remedial Action

Antifraud Violations

Respondent, a former associated person of a registered broker-dealer, violated antifraud provisions by making secret cash payments to state treasurer in return for state securities business. *Held*, it is in the public interest to bar Respondent from associating with any broker or dealer, impose a cease-and-desist order, require disgorgement of $938,353.78, plus prejudgment interest, and assess a $500,000 third-tier civil money penalty.

APPEARANCES:

Michael K. Wolensky, *Ethan H. Cohen*, and *Tammy A. Bouchelle*, of Schiff Hardin LLP, *Robert J. Gorence*, of Gorence & Oliveros, P.C., and *Timothy M. Padilla*, of Padilla & Associates, for Guy P. Riordan.

Nancy J. Gegenheimer, *Elizabeth E. Krupa*, and *Allison H. Lee*, for the Division of Enforcement.

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Appeal filed: August 18, 2008
Last brief filed: November 28, 2008
Oral Argument: November 2, 2009

I.

Guy P. Riordan ("Riordan"), a former registered representative associated with Wachovia Securities, LLC ("Wachovia"), previously known as First Union Securities, Inc. ("First Union"), appeals from an administrative law judge's decision.[1] The law judge found that, from around 1996 through December 2002 (the "relevant period"), Riordan engaged in a scheme to defraud and course of business that operated as a fraud or deceit on citizens of the State of New Mexico (the "State") by making secret cash payments to Michael Montoya, the former New Mexico State Treasurer (the "Treasurer"), in exchange for obtaining agency securities transactions from the New Mexico State Treasurer's Office (the "NMSTO"), in willful violation of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Exchange Act Rule 10b-5.[2] The law judge barred Riordan from association with any broker or dealer; entered a cease-and-desist order; required disgorgement plus prejudgment interest; and assessed third-tier civil money penalties of $500,000. We base our findings on an independent review of the record, except with respect to findings not challenged on appeal.[3]

II.

This case involves corruption in the NMSTO in connection with its investment of State funds in agency securities[4] by private broker-dealers between 1996 and 2002. Montoya was the Treasurer throughout this period and provided extensive testimony before the law judge that he

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[1] *Guy P. Riordan*, Initial Decision Rel. No. 353 (July 28, 2008), 93 SEC Docket 8408. Before First Union, Riordan's firm was known as Everen Securities.

[2] 15 U.S.C. §§ 77q(a), 78j(b), & 17 C.F.R. § 240.10b-5.

[3] Commission Rule of Practice 451(d), 17 C.F.R. § 201.451(d), permits a member of the Commission who was not present at oral argument to participate in the decision of a proceeding if that member has reviewed the oral argument transcript prior to such participation. Commissioners Aguilar and Paredes conducted the required review.

[4] "Agency securities" include securities issued or guaranteed by the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal Home Loan Banks ("FHLB").

received secret cash kickbacks[5] from registered representatives in exchange for agency securities transactions from the NMSTO. Testimony was also provided by another former NMSTO employee who admitted to manipulating the NMSTO's bidding process, at Montoya's request, in order to award NMSTO agency securities transactions to Riordan. NMSTO bid records, which showed the various ways in which Montoya rigged the bidding process in Riordan's favor, further confirmed the existence of the kickback scheme.

A. The Kickback Scheme.

1. The beginning of the scheme.

Montoya first met Riordan, an Albuquerque-based registered representative, when he ran for, and lost, the Democratic primary for Treasurer in 1990. Montoya asked Riordan, who was an active member of the Democratic Party, to support him in the next election for Treasurer in 1994. Riordan agreed and helped Montoya raise campaign funds and votes. Montoya won the election and took office in January 1995. He was reelected to a second term in 1998 and served until December 31, 2002.[6]

As Treasurer, Montoya was responsible for safeguarding the State's money and investing it in various instruments, including agency securities. Montoya learned early on that certain brokers, including Riordan and Trent Tucker,[7] formerly of Southwest Securities, Inc., were

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[5] A "kickback," in comparison to other forms of corrupt payments, is generally defined as a "return of a portion of a monetary sum received, especially as a result of coercion or a secret agreement." *Black's Law Dictionary* 874 (7th ed. 1999).

[6] State term limits prevented Montoya from seeking a third term.

[7] At the hearing, Tucker, also an Albuquerque-based registered representative, admitted that he paid cash to Montoya in exchange for obtaining NMSTO agency securities transactions during the period from 1998 to 2002. Tucker would meet Montoya in restaurants where Montoya would ask him for "help" or for a charitable donation, and Tucker would give him $300 or $500 in cash. Tucker entered into a settlement with the Commission in which he was ordered to cease and desist from committing or causing any violations and any future violations of the antifraud provisions of the Securities Act and Exchange Act, and barred from associating with any broker or dealer. No civil penalties were assessed, and disgorgement of $290,000, plus prejudgment interest, was waived based on an inability to pay. *Trent L. Tucker*, Securities Exchange Act Rel. No. 56524 (Sept. 25, 2007), 2007 WL 2778641.

Montoya identified Robert Sanchez as a third registered representative who paid him kickbacks in return for NMSTO agency securities transactions. Riordan listed Sanchez as a witness who would "disprov[e] facts alleged in [the] Order Instituting Proceedings," but did not

(continued...)

willing to "help [him] out," meaning that they would give him cash kickbacks in exchange for obtaining agency securities transactions from the NMSTO.

Montoya testified that Riordan started paying him kickbacks "probably [in] late 1995 or early 1996." Montoya would ask Riordan to "help [him] out," and they developed a pattern where, after Riordan participated in a transaction with the NMSTO, Montoya would meet Riordan in person,[8] frequently at a restaurant for lunch. At some point during the meal, they would retreat to the restroom and Riordan would pay Montoya the money. Montoya did not have a set formula for the amount that Riordan should pay. Montoya stated that they "worked out a deal" that, for any transaction Riordan received from the NMSTO, Montoya would get a portion of the commissions Riordan earned on the transaction.[9] The payments ranged from $300 to $500 per transaction, with $2,500 or $3,000 as the highest amount that Montoya received from Riordan on any one transaction. Riordan initially paid Montoya by check so that the payments appeared as campaign contributions, but later, they switched to cash in order to "disguise . . . that [Montoya] was getting money."[10]

While Montoya testified that Riordan did not pay him kickbacks on sales transactions, he qualified this testimony by stating that it was his "best guess" and that he was "confused." Montoya thought that most of Riordan's transactions on behalf of the NMSTO were purchases, and he did not know whether Riordan earned commissions on the sales. However, eight of Riordan's eighteen transactions with the NMSTO between January 2001 and October 2002 were sales, and Riordan admitted that he earned commissions on sales, as well as purchases. Montoya testified that he generally was paid after each transaction, and that he could not recall a single instance in which he did not receive a kickback from Riordan after Riordan had won a

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7 (...continued)
call him to testify at the hearing after Sanchez notified all counsel that he would assert the Fifth Amendment if called.

8 Montoya testified that he obtained kickbacks from Riordan in person, rather than through an intermediary, because he felt "very comfortable" with Riordan. By contrast, Montoya testified that he would use Leo Sandoval, an NMSTO employee, as an intermediary to collect kickbacks from certain California-based investment advisers in connection with the NMSTO's investment in repurchase agreements because he "really didn't know [them] that well" and "felt an extra layer of protection would be better." *See infra* note 36.

9 Montoya testified that he and Riordan "never talked about" their payment arrangement because "we both knew what I wanted or what he should pay." The FBI could not find that Montoya kept any records of the kickback money he received from Riordan. Because payments were in cash, Montoya testified that he spent it "fast," essentially "throwing it away."

10 No cancelled checks were offered into evidence for this early period.

transaction.[11] According to Montoya, he would not award another transaction to Riordan until he had been paid on the last transaction. Montoya also testified that Riordan knew that, if he did not pay a kickback, he would not receive preferential treatment from Montoya on future transactions. As discussed below, the evidence indicated that Riordan received preferential treatment in the bidding process for sales transactions and that he, in fact, paid kickbacks on the sales, as well as purchases.

2. The mechanics of the scheme.

Montoya was obligated to follow the State's Investment Policy, which required "all securities purchases/sales [to be transacted] only through a formal and competitive process" with the consideration of at least three bids: one from "the successful firm in the immediately preceding transaction"; one from a broker "physically located in the State"; and one from a "primary reporting dealer."[12] The Investment Policy also required the State to accept purchase bids which "provide[d] the highest rate of return within the maturity required" and to accept sale bids which "generate[d] the highest sales price." The Investment Policy stated that "[s]ecurities broker/dealers with offices in New Mexico [would] be given priority when possible over out-of-state dealers."[13] The Investment Policy further required that brokers be on a list that had been approved by the State Board of Finance before they could participate in the bidding process. First Union (Riordan) and Southwest Securities (Tucker) were the only in-state brokers of twelve brokers on the approved list in 2001 and 2002.

Montoya testified that the NMSTO was not subject to "thorough oversight" and that the State Auditor's Office "didn't know much about investment paper." As a result, Montoya was able to award transactions to Riordan for kickbacks and disguise the bidding to make it appear

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11 Montoya testified that there might have been a few times when he did not receive a kickback from Riordan because Riordan claimed he did not make any money on a transaction, but that such a situation was "very rare."

12 The term "primary reporting dealer" is not defined by the Investment Policy. The term "primary dealer" is defined by the Federal Reserve Bank of New York as select "banks and securities broker-dealers that trade in U.S. Government securities with the Federal Reserve System" and "report weekly on their trading activities." Federal Reserve Bank of New York, Fedpoint "Primary Dealers," *available at*: http://www.newyorkfed.org/aboutthefed/fedpoint/fed02.html. Although Riordan testified that First Union and Wachovia were "primary issuers," the record does not establish that they met the definition of "primary dealer." Neither First Union nor Wachovia appears on any "primary dealer" list published by the Federal Reserve Bank of New York since 1999. *See* http://www.newyorkfed.org/markets/pridealers_listing.html.

13 The Investment Policy did not explain what was meant by giving local firms "priority when possible." *See infra* note 64 and accompanying text.

that Riordan had legitimately won bids through a formal, competitive process.[14] Montoya stated that, in the beginning, he had difficulty directing business to Riordan because his then Chief Investment Officer, David Abbey, was not willing to manipulate the bidding process. Indeed, Abbey testified that, while he was Chief Investment Officer, Riordan was not generally successful on competitive bids. However, Abbey left the NMSTO in 1996.

In late 1996, Montoya placed Leo Sandoval, a childhood friend, in charge of awarding NMSTO bids on agency securities transactions because he trusted Sandoval to "do what [he] wanted." Montoya's practice was to tell Sandoval who he wanted to win the bid and to ensure that the person won.

Montoya testified that there were various ways to rig the bidding process and make it appear to the State Auditor's Office that his awarding of bids on NMSTO securities transactions was in compliance with the Investment Policy's requirements.[15] On some occasions, Montoya testified, he would instruct Sandoval to give Riordan the "last look," meaning to tell Riordan what other brokers were bidding so that Riordan could submit a bid with a better rate.

On other occasions, Montoya would allow Riordan to have a longer settlement date, or quote agency securities with a longer maturity date, than the other brokers. A longer maturity date would command a higher yield so Riordan's bid would appear to have a higher rate of return, and thus appear to be the best bid.[16] Montoya also would permit Riordan to bid much later than other bidders, which enabled Riordan to adjust his bid and obtain the "best rate," after the market had improved. Montoya knew that his actions were "dishonest" and that he was not being "fair" to the other brokers because they were not bidding on the "same type of paper" or given the "same chance" as Riordan.

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[14] Montoya testified that, "for the most part when we would [solicit bids], everybody was calling in on the same paper. So it's pretty much left to us who we're going to pick that morning. There [were] variations of a basis point or two. . . . [W]e came to learn that the State's Auditor's office -- we didn't have any oversight on anybody's part in seeing what we were doing. So after a couple of years nobody was watching us, so we were just giving basically paper to whoever [sic] we wanted to."

[15] Montoya revealed that "[i]t wasn't that hard to get three bids and to change the documents around or just to do what we wanted. I mean it became very easy to do what we wanted."

[16] Montoya explained that "any variation of the [agency] paper that you're asking for carries different investment rates so any -- with one little change, it changes the entire paper from one to two to three basis points, and as long as you're one basis point higher, you have better paper." A "basis point" is one-hundredth of a percentage point (0.01%).

Sandoval testified that Montoya directed him to contact Riordan on "many, many" occasions and give Riordan the "last look," confirming Montoya's testimony that he used the term to indicate that Sandoval was to do "[w]hatever it took" to ensure that Riordan won the transaction. Sandoval stated that the number of times that Montoya directed him to give Riordan the "last look" was "too many to count." Sandoval affirmed that, for every purchase or sale of agency securities, he was told to contact "either Mr. Riordan or Mr. Tucker, but for the most part Mr. Riordan."

In 2000, the NMSTO was audited and one of the audit exceptions was the failure to maintain records of the bidding for securities transactions, as required by the Investment Policy. Following the audit, Montoya instructed Sandoval to keep records of all the bids and require brokers to confirm oral bids by facsimile transmission. Sandoval began keeping bid records in 2001, but testified that he would alter them by removing the facsimile lines, which showed the dates and times that the bids were submitted to the NMSTO, in order to disguise the fact that Riordan's bids frequently came in last.[17]

Sandoval, like Montoya, knew that telling Riordan "what the other two bids were" was unfair because he did not contact Riordan's competitors and give them the same information. As Sandoval stated, if he had given this information to all the bidders, then the State could have received a better price because it would have been more "like an auction." Sandoval acknowledged that, "in this case, the other two bidders weren't given that opportunity."

Sandoval also testified that, during his employment at the NMSTO, Montoya told him that he, Montoya, was receiving money from Riordan in exchange "for giving [Riordan] the last look and for [Riordan] winning the bids." However, Sandoval testified that he never witnessed Riordan giving any money to Montoya.[18]

3. Riordan's secret tape recordings of Montoya's requests for cash.

In his testimony, Riordan confirmed that Montoya asked him for kickbacks and that, on occasion, he gave money to Montoya. However, Riordan denied that the payments were kickbacks for NMSTO business, and denied that he was ever given a "last look" by the

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[17] Sandoval kept the bid records for 2001 and 2002 in two binders, which he turned over to law enforcement authorities in December 2003.

[18] Sandoval entered into an immunity agreement with the U.S. Attorney's Office in which it agreed not to prosecute him provided he cooperated and gave truthful testimony. The State indicted Sandoval (who subsequently received a suspended sentence and was placed on supervised probation for three years, *see State v. Sandoval*, D-101-CR-200600265 (Santa Fe D. Ct. June 30, 2009)), but gave him use immunity regarding the testimony that he gave in this administrative proceeding. Sandoval had no immunity agreements with the Commission.

NMSTO.[19] Rather, Riordan asserted that, to the extent he gave money to Montoya, he did so lawfully in the form of political campaign contributions, which he typically paid to Montoya at fundraising events.[20]

In late 1997, Riordan secretly tape recorded three months of conversations with Montoya and other NMSTO employees, including Ron Beserra, Montoya's then Deputy Treasurer.[21] According to Riordan, he made the recordings because he became upset when Montoya said that he did not want a bottle of Dom Perignon champagne that Riordan gave to his large customers over the holidays, but a "green tree,"[22] which Riordan understood to mean cash. Riordan stated that the request made him concerned about Montoya's business practices and prompted him to record their conversations in case he "needed to bring it to the authorities." Riordan claimed that he told Montoya that he was "not going to play his game," but this statement did not appear on the tape.

In one taped conversation, Montoya expressed an interest in using Riordan to purchase a four-year bond with a two-year call provision.[23] As the two men discussed the possible transaction, Montoya casually asked Riordan to meet him and for payment of a "green tree":

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19 Through a forensic accounting expert, Riordan attempted to show that he did not have access to sufficient cash in his bank accounts in 2001 and 2002 to pay kickbacks. However, during the expert's testimony, it was discovered that Riordan had failed to inform the expert of his wife's $100,000 line of credit, $96,430.39 of which had been drawn by September 2001.

20 From 1995 to 1999, Riordan and others sponsored an annual golf tournament that each raised between $14,000 and $18,000 for Montoya's campaign. Riordan testified that the money -- checks and cash -- "[u]sually . . . would be turned over [to Montoya] at the golf tournament." Riordan added, somewhat ambiguously, that "there may have been some occasion where . . . I'd say . . . 'I've got to give you this [money].' Wouldn't tell him what it was or what it was for. That was in the '90s during these golf -- everything was related, absolutely, to those golf tournaments."

21 Although covered by a July 2007 subpoena, Riordan did not produce the tape recordings and accompanying transcript until two weeks before the December 2007 hearing. When questioned at the hearing, Riordan gave two different explanations for why he did not timely produce the tape recordings and transcript in response to the July 2007 subpoena: (1) he forgot he made the tapes, and (2) he remembered taping Montoya, but he did not know where the tapes were.

22 Riordan's testimony indicates that Montoya first mentioned his preference for a "green tree" in an earlier conversation that Riordan did not record.

23 A call provision, set forth in the indenture of a bond, allows an issuer to "call," or redeem, the bond before its maturity date.

Montoya:	And this would be a four year, two [purchase]?
Riordan:	Four year, two.
Montoya:	And what time is a good time this afternoon [to meet]?
Riordan:	Oh, I think I can meet you about 2 o'clock.
Montoya:	2 o'clock at –
Riordan:	You can stop by. I've got to go over to Kelly's [liquor store in Albuquerque].
Montoya:	Where at? No, no, no. I don't want no Kelly's.
Riordan:	I'm getting you a nice bottle of champagne, dude.
Montoya:	No, no, no. I don't drink that stuff. Please no, no, no. I'd like a green tree. Hey, how about 2 o'clock [at Bennigan's restaurant]?
Riordan:	That's fine.

Riordan testified that he was "disgusted" by Montoya's request for cash, but such a reaction was not evident in his tone of voice on the tape nor by his willingness to meet Montoya at Bennigan's. The conversation continued for a short time period with Montoya indicating a commitment by the NMSTO to invest with Riordan in the four-year bond with the two-year call provision.[24]

Riordan testified that, when he met Montoya at Bennigan's, "I brought him a bottle of Dom Perignon [champagne] and I had a discussion with him – [a] rather harsh discussion that . . . I was upset" with him for requesting cash.[25] Riordan, however, admitted that he did not record this conversation or any other conversation in which he purportedly told Montoya that he would not pay cash in exchange for NMSTO business.[26]

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[24] In the middle of another taped conversation concerning a purchase transaction, Montoya told Riordan, "We need some help," and Riordan replied, "I always help."

[25] At the hearing, Montoya did not remember Riordan having a harsh discussion with him over his request for a cash kickback. In explaining why he turned down Riordan's offer of champagne, Montoya testified that Riordan "was always coming up with wanting to take me to Las Vegas or buying me champagne or taking me to the Kings basketball games or St. Louis for Mark McGuire, and other things. And I really didn't want any of that. I wanted him to know I don't want any of that. All I want is money."

[26] Riordan's secret tape recorded conversations reflected that Riordan knew how to record an in-person conversation if he wanted to do so. During one conversation, then Deputy Treasurer Beserra told Riordan about the pressures of working with Montoya because he "didn't play." Riordan advised Beserra to "wear a jacket" and tape his conversations with Montoya. Although Riordan listed Beserra as a witness who would "disprov[e] facts alleged in [the] Order Instituting Proceedings," he did not call Beserra to testify at the hearing.

After Montoya asked for a "green tree" in 1997, Riordan testified that he "suspected [Montoya] was crooked." Nonetheless, Riordan did not take his tape recordings to the authorities because, based on his conversation with Montoya at Bennigan's, he "[t]hought [he] had Montoya in check and . . . had him towing [sic] the line."[27] Riordan continued doing substantial securities business with Montoya on behalf of the NMSTO, engaged in political fundraising for Montoya's reelection campaign in 1998, and paid for a Las Vegas, Nevada, hotel room for Montoya on February 23, 1999.[28]

4. The end of the scheme.

Montoya testified that his kickback arrangement with Riordan continued until the end of his term in office. In October 2002, Montoya awarded Riordan the last five agency securities transactions of his term as Treasurer. The five transactions were valued at $150 million and consisted of four sales and one purchase of agency securities, as follows: (1) a purchase of $50 million; (2) a sale for $20 million; (3) a sale for $20 million; (4) a sale for $35 million; and (5) a sale for $25 million.

According to Montoya, Riordan was slow to pay the kickbacks for these transactions. Montoya surmised that Riordan knew that his time in office was ending and he could no longer help Riordan obtain NMSTO transactions. Montoya called Riordan repeatedly for the kickbacks but Riordan would not return his calls. Frustrated, Montoya left "threatening" voice messages on Riordan's telephones, stating, "Guy, you know you owe me this money, what do you want me to do? I'm not going to go anywhere until I get paid." Montoya testified that Riordan eventually returned his calls in mid-December 2002 and agreed to meet him at a Kicks 66 gas station near Montoya's home. According to Montoya, when he arrived at the gas station, "I got into [Riordan's] car. He threw the $500 or $700 [in kickbacks] and told me never to call him back again and never to threaten him again. And that's the last time I ever talked to him." Montoya acknowledged that these were the last payments he received from Riordan.

Riordan's testimony confirmed that Montoya had left him threatening voice messages. Riordan admitted that Montoya was "very, very mad" at him and was demanding kickbacks for the October 2002 transactions. Riordan also admitted that, in response to the threatening

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27 Riordan claimed that Montoya "never stepped over that line" with him again until October 2002 when Montoya called and demanded money because Riordan had completed five agency securities transactions (four sales and one purchase) with the NMSTO.

28 At the hearing, Riordan denied that he "bought a [hotel] room" for Montoya. Rather, Riordan claimed that February 23, 1999, fell on Super Bowl weekend, and that he merely helped Montoya reserve a room. The record showed that the 1999 Super Bowl, in fact, occurred on January 31, 1999. Moreover, hotel receipts dated February 23,1999, showed Riordan's name and signature on a room for "Montoya, Michael" and that Riordan himself stayed in a separate room that night.

messages, he willingly agreed to meet Montoya at the Kicks 66 gas station. The two men sat in Riordan's vehicle, where, by Riordan's account, Montoya again demanded money, complaining that Riordan was raising money for other politicians, but not for him. Riordan claimed that they had "an exchange of words," but denied that he paid Montoya kickbacks for the October 2002 transactions. Riordan agreed with Montoya that it was the last time they spoke.

Over the course of the relevant period, Riordan's transactions with the NMSTO generated substantial income for him.[29] He bid successfully on over one hundred agency and corporate bond transactions with the NMSTO.[30] In 2001 and 2002, when Sandoval kept bid records, Riordan won eighteen of twenty-nine bids submitted to the NMSTO for a 62% success rate.[31] For these years, his winning bids amounted to 43% of the total value of NMSTO awards -- $630 million of approximately $1.45 billion.[32] Riordan earned $1,017,278.78 in total commissions from 1996 through 2002, including bonuses for 2001 and 2002, on agency and corporate bond transactions with the NMSTO.[33] In 2001 and 2002 alone, Riordan's earnings on NMSTO agency and corporate bond transactions amounted to $401,540.50, which constituted 71% of $564,099.10, his total earnings with Wachovia.[34]

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29 Riordan testified that he chose not to do business with the NMSTO, and did not submit any bids, during the eighteen-month period from June 1999 until January 2001 because interest rates were rising.

30 As reflected in Riordan's Wachovia commission reports, his most productive year, in terms of number, was 1998 -- the year after he secretly tape recorded his conversations with Montoya -- when he was awarded forty-one agency securities transactions, earning him approximately $351,916 in commissions.

31 Riordan notes that, in 2001, the NMSTO only awarded him one bid to purchase agency securities. However, Riordan, in fact, won five of the eight times that he bid on the total number of purchase and sales transactions that year.

32 Montoya testified that he generally awarded the larger dollar volume transactions to Riordan and Tucker. The NMSTO's records showed that, in 2001 and 2002, Riordan and Tucker together won 82% of the dollar volume of transactions, with the remaining 18% spread out among the eleven other brokers on the NMSTO's approved broker list.

33 The $1,017,278.78 consisted of $615,738.28 in commissions for the years 1996 through 2000, and $401,540.50 in commissions, including bonuses, for the years 2001 and 2002. Riordan earned a total of $57,677 in bonuses between 2001 and 2002. Neither Riordan nor Wachovia provided bonus information for the period prior to 2001.

34 The Division's expert witness, James McKinney, found it "pretty extraordinary" that, in a two-year period, Riordan earned over $400,000 from just one account.

5. Montoya's arrest and conviction.

Sandoval remained employed at the NMSTO after Montoya left office. In 2003, the U.S. Secret Service raided the NMSTO as part of a counterfeiting investigation involving Sandoval. Sandoval then disclosed the corruption in the NMSTO involving Montoya and Robert Vigil, who served as Montoya's Deputy Treasurer during his second term in office and succeeded him as Treasurer. Sandoval's disclosures led the Secret Service to transfer the investigation to the Federal Bureau of Investigation ("FBI").[35]

In late 2003, the FBI began an investigation into an unrelated kickback scheme during Montoya's and Vigil's administrations involving investment advisors and repurchase agreements.[36] The FBI's investigation led to the arrest of Montoya, Vigil, and others. On the day of his arrest in September 2005, Montoya admitted his guilt with respect to the repurchase agreement scheme, which involved over a million dollars in kickbacks.[37] He also confessed to

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[35] Sandoval and Angelo Garcia, another individual who acted as an intermediary for Montoya and collected kickbacks, cooperated with the federal government and became FBI informants. Both Sandoval and Garcia secretly recorded conversations with Montoya for the FBI before Montoya's arrest.

In December 2003 and April 2005, Sandoval gave statements to the FBI that Riordan received preferential treatment from the NMSTO in return for his payment of cash to Montoya. In March 2004 and August 2004, Garcia gave statements to the FBI implicating Riordan in "kickbacks and illegal securities activity."

Riordan listed Sandoval and Garcia as witnesses who would "disprov[e] facts alleged in [the] Order Instituting Proceedings." However, Riordan did not call Garcia to testify at the hearing, and Sandoval testified for the Division.

[36] A "repurchase agreement" is an "agreement between a seller and a buyer, usually of U.S. Government securities, whereby the seller agrees to repurchase the securities at an agreed upon price and, usually, at a stated time." Barron's Dictionary of Finance and Investment Terms, 476 (4th ed. 1995). The repurchase agreements were the subject of a separate scheme, not at issue here, that was charged in a criminal indictment against Montoya. Thus, Riordan's claims that he was not implicated in Montoya's criminal action and was not approved to bid on repurchase agreements are irrelevant here.

[37] Montoya pleaded guilty to one count of extortion, in violation of 18 U.S.C. § 1951, and was sentenced to forty months in prison. *See United States v. Montoya*, 1:05-CR-02050-001 JP (D.N.M. Sept. 27, 2007). As part of his plea agreement, Montoya agreed to testify against Vigil. Based on Montoya's cooperation and assistance, the prosecution sought a reduced

(continued...)

his participation in a smaller kickback scheme involving agency securities transactions and implicated Riordan in that scheme.

B. NMSTO's Records and Expert Testimony.

1. The NMSTO's records confirmed that the bidding was rigged and that Riordan received preferential treatment in the bidding.

The NMSTO's records confirmed that Montoya and Sandoval rigged the bidding process and concealed the kickback scheme. As Sandoval described, the bid documents often had the facsimile transmission lines removed to disguise the fact that Riordan's bids were submitted last, after Sandoval disclosed to Riordan the competing bids. When Sandoval neglected to remove the facsimile transmission lines, the bid documents showed that Riordan's bids came in last, often much later than the other bids. For example, on December 11, 2001, Montoya awarded Riordan a $25 million sale of FHLB securities. Riordan's bid was submitted several hours after the bids of the other two brokers, Paine Webber and Dain Rauscher, and after an announcement by the Federal Reserve Bank that caused bond prices to spike upward.[38] The Division's expert witness, James McKinney, opined that the NMSTO did not consider three competitive bids because "[i]t [was] inconceivable that any quote, hours earlier, would still be relevant." McKinney concluded that Riordan was advantaged by bidding near the close of the market and knowing of the Federal Reserve Bank's announcement. Riordan's expert witness, Guy Perrone, did not refute McKinney's conclusion that the bidding process was unfair to Riordan's competitors. Rather, Perrone suggested that the NMSTO's decision to accept a late bid from Riordan was "possibly" "[a] lapse in policy."

Consistent with Montoya's testimony, the bid documents reflected that the NMSTO allowed Riordan to quote agency securities with longer investment maturities than his competitors so that Riordan would appear to have better rates of return. For example, on

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37 (...continued)
sentence. The sentencing judge, who had observed Montoya testify against Vigil, stated that he was "highly impressed by [Montoya's] candor."

Vigil was convicted of attempted extortion, in violation of 18 U.S.C. § 1951, and sentenced to thirty-seven months in prison. *See United States v. Vigil*, 1:05-CR-02051-001 JB (D.N.M. Feb. 22, 2007), *aff'd*, 523 F.3d 1258 (10th Cir. 2008), *cert. denied*, 129 S. Ct. 281 (2008). Vigil, who was not charged with any involvement in the scheme at issue here, was in prison when the law judge conducted the hearing in this proceeding.

38 *See* Press Release, Federal Reserve (Dec. 11, 2001), *available at* http://www.federalreserve.gov/boarddocs/press/general/2001/20011211/default.htm (Federal Reserve Bank announcement that it was cutting the federal funds rate by twenty-five basis points).

August 15, 2002, Montoya awarded Riordan a $75 million purchase of FHLB securities. Riordan bid on securities with a three-year, four-month maturity, while his two closest competitors, Dain Rauscher and Banc of America Securities, bid on securities with a three-year maturity. The three-year, four-month security had another advantage because it was issued at a time when the yield curve was sloping upward. Perrone agreed with McKinney that the type of securities differed, stating that "they're not three of the same bids." Perrone also opined that, to obtain the best yield, it appeared that the NMSTO "bent Investment Policy rules by extending their maximum maturity by three months."

On October 1, 2002, Montoya awarded Riordan a $50 million purchase of FHLB securities. Again, Riordan was allowed to quote different terms compared to the other brokers. As submitted, Riordan quoted a 3.26% yield on a three-year, three-month bond.[39] In contrast, his two competitors, Bear Stearns and Dain Rauscher, submitted almost identical bids on a three-year bond and quoted yields of 3.125% and 3.130%. McKinney stated that, although Riordan's bid rendered the highest yield of the three bids, the bidding was not competitive because Riordan was "not bidding on the same paper" and was given a "significant yield advantage" by virtue of extending the maturity date. Perrone effectively agreed, stating that, "[o]nce again[,] the NMSTO's office bent their o[w]n rules to seek out the best yields."

2. The experts agreed that the bidding was noncompetitive and that Riordan was favored in the bidding.

As discussed, the Investment Policy required a "formal and competitive process" to award bids on securities transactions. McKinney found that the NMSTO's bidding process was "rigged." He opined that the NMSTO's bid records were "full of inaccuracies" and assembled "after the fact, and . . . in some cases weeks later . . . to try to feather a file . . . [and] make it look like there was a real competitive situation." Although disagreeing with some of McKinney's conclusions, Perrone reviewed McKinney's report and stated that, "overall," he thought that McKinney's analysis of the trades was "reasonable and correct." Perrone found evidence that some brokers were given a "second look," or allowed to submit a second bid, and he considered that to be "inappropriate." Perrone agreed that Riordan was given preference in the bidding process.

According to McKinney, in a truly competitive situation, the NMSTO would have placed a deadline on the time for submitting bids, which would have caused bids to be submitted by brokers "seconds" apart. By contrast, in this case, the bidding process remained open for a long time with no firm bids. McKinney considered the "last look" given to Riordan to be inappropriate because trading in agency securities is rapid. McKinney stated that bids are good for about a maximum of thirty seconds because the market moves so quickly. McKinney testified, "No one is going to leave a trade out for three to four hours." The fact that Riordan was

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39 The facsimile transmission time was also cut off on the NMSTO's copy of Riordan's bid.

permitted to place a winning bid several hours after the other brokers had bid, and after the market had moved, was, in McKinney's view, a "no brainer" indicating that the NMSTO's bidding process was not competitive.[40]

McKinney also noted that many of the NMSTO's transactions awarded to Riordan had long settlement dates. Indeed, Riordan's bids had the highest average number of days between the trade date and settlement date.[41] McKinney referred to this technique as forward delivery, where the dealer offered a new issue security that settled in the future, rather than next-day settlement, the standard settlement date in U.S. Treasury and agency securities transactions. McKinney explained that the use of the forward-delivery technique "on the surface made an offer higher yielding and *appear* to be better," when, in fact, it resulted in comparing bids of "apples and oranges." (emphasis in original). For example, the $30 million purchase of FHLB securities with a trade date of April 22, 2002, and a settlement date of June 3, 2002, awarded to Riordan, whose bid was the highest by seventeen basis points, did not indicate that the NMSTO took the best bid. According to McKinney, if the NMSTO had allowed Riordan's competitors to also submit bids with a "30, 40"-day settlement period, rather than the standard next-day settlement, their bids would have been more competitive with Riordan's bid. Perrone agreed that the bids were dissimilar, stating that "an extra two months might buy an extra 10 or 15 basis points."

McKinney opined, and the NMSTO's records reflected, that Riordan won the four sales transactions awarded to him in October 2002 even though they were the "worst" bids. As the NMSTO's records showed, Riordan's bids had the highest yields of the three bids placed on each of the four transactions. McKinney testified that the price of a bond has an inverse relationship with the bond's yield: the higher the yield, the lower the price of the bond.[42] Thus, by having the highest yields on all four sales, Riordan's bids brought in the lowest prices for the State. Perrone agreed and stated that Riordan "won all four items despite being the lowest bidder." In seeking

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[40] McKinney found it unusual, considering the highly competitive firms on the NMSTO's list of approved brokers, that First Union could have been "so consistently successful if the [bidding] process was truly fair and transparent." McKinney also found it unusual for a buyer of the NMSTO's magnitude to deal so frequently with a retail salesman, as he characterized Riordan, rather than an institutional salesperson.

[41] During 2001 and 2002, Riordan averaged thirty-two days between trade and settlement dates. All other registered representatives, besides Tucker, who purchased agency securities averaged a combined fourteen days for their transactions. In one example, Riordan took fifty days to settle the transaction, after the NMSTO awarded him a $50 million sales transaction on May 29, 2002.

[42] *See* Frank J. Fabozzi, *Bond Markets, Analysis and Strategies* 22 (1996) ("A fundamental property of a bond is that its price changes in the opposite direction from the change in the required yield . . . . As the required yield increases, the present value of the cash flow decreases; hence the price decreases. The opposite is true when the required yield decreases.").

to explain why Riordan was awarded the four sales transactions when his bids were the worst, Perrone speculated that "the person excepting [sic] the bids may have been confuse [sic] and awarded the sales to the highest yield." Perrone added, "I can't give a better explanation."

III.

The antifraud provisions of the federal securities laws, Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5, prohibit, among other things, employing a scheme to defraud and any act, practice, or course of business which operates as a fraud or deceit in connection with the offer, sale, or purchase of securities.[43] Federal courts and the Commission have uniformly held that kickback schemes violate these antifraud provisions.[44]

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[43] *See* 15 U.S.C. §§ 77q(a), 78j(b); 17 C.F.R. § 240.10b-5. The Division has not argued, and therefore we do not address, Riordan's antifraud liability under a theory of material misrepresentations or omissions.

[44] *See, e.g., SEC v. Washington County Util. Dist.*, 676 F.2d 218, 224-27 (6th Cir. 1982) (undisclosed kickback scheme between underwriter and official of municipal securities issuer violated the federal securities laws); *SEC v. Zwick*, No. 03-Civ-2742, 2007 WL 831812, at *16-17 (S.D.N.Y. Mar. 16, 2007) (kickback scheme violated Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5), *aff'd*, 317 Fed. Appx. 34 (2d Cir. 2008) (unpublished); *SEC v. Savino*, No. 01-CV- 2438, 2006 WL 375074, at *1 & *12-13 (S.D.N.Y. Feb. 16, 2006) (secret kickback agreements "constitut[ed] an illegal scheme to defraud" under Exchange Act Rule 10b-5), *aff'd in relevant part*, 208 Fed. Appx. 18 (2d Cir. 2006) (unpublished); *SEC v. Santos*, 355 F. Supp. 2d 917, 919 (N.D. Ill. 2003) (SEC complaint alleging that defendants participated in kickback scheme stated securities fraud claim under Exchange Act Rule 10b-5); *SEC v. Feminella*, 947 F. Supp. 722, 731-32 (S.D.N.Y. 1996) (SEC stated claim for illegal kickback scheme under Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5); *United States v. Rudi*, 902 F. Supp. 452, 456-57 (S.D.N.Y. 1995) (undisclosed scheme by which financial adviser to local government authority received kickbacks from lead underwriter of bond issue for government authority constituted fraud "in connection with" sale of bonds under Exchange Act Section 10(b) and Exchange Act Rule 10b-5); *Stephens Inc.*, Exchange Act Rel No. 40699 (Nov. 23, 1998), 68 SEC Docket 1854, 1863 (settled proceeding) (respondent's payment of secret kickbacks to public officials to obtain municipal securities business violated Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5); *First Fid. Sec. Group*, Exchange Act Rel. No. 36694 (Jan. 9, 1996), 61 SEC Docket 68, 75 (settled proceeding) (kickback scheme violated Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5).

A. Riordan is Liable for Violating the Antifraud Provisions.

The preponderance of the evidence[45] established that, over a seven-year period, Riordan made secret cash payments to Montoya in exchange for Montoya selecting Riordan's bids for the NMSTO's purchases and sales of agency securities.[46] Riordan began making secret cash payments to Montoya in approximately 1996, and he continued to do so through the end of Montoya's term in December 2002. During Montoya's tenure, the State's Investment Policy required that securities transactions be conducted through a "formal and competitive" bidding process with an evaluation of at least three bids. The Investment Policy required that purchase transactions be awarded to the bid resulting in the highest return "within the maturity required," and that successful sale bids generate "the highest sale price." In violation of the Investment Policy, Montoya rigged the bidding process to make it appear that Riordan had been awarded transactions through a competitive bidding process in order to obtain cash kickbacks.

Montoya caused the NMSTO to obtain bids from other brokers first, then notify Riordan of the terms of the other bids, enabling Riordan to provide a bid with a better rate. Montoya also permitted Riordan to bid substantially later than other bidders, and to bid using bonds with longer maturity dates. As a result of the bid rigging, Riordan won eighteen of twenty-nine bids submitted to the NMSTO between 2001 and 2002, for a 62% success rate, which was substantially higher than any other bidder on the State's list of approved brokers. Between 2001 and 2002, Riordan's winning bids amounted to 43% of the total value of successful bids, or $630 million of approximately $1.45 billion.

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45 *See Steadman v. SEC*, 450 U.S. 91, 102 (1981) (applying preponderance of the evidence standard in Commission administrative proceedings).

46 Riordan's secret kickback payments to Montoya constituted material information because, at a minium, such an arrangement could cause a reasonable investor, in this case, the State, to question the quality of NMSTO's management and integrity of its bidding process for securities transactions. *See, e.g.*, *Washington County*, 676 F.2d at 225 (stating that failure to disclose kickback payments received as part of illegal kickback scheme involving district bonds was material because "an investor, had he known of the payments, could have reasonably concluded that investment in the . . . bonds was unwise because the kickbacks increased the costs of the offering"; stating further that "an investor could have concluded that the . . . bonds were a poor investment because the quality of the [d]istrict's management was suspect"); *Savino*, 2006 WL 375074, at *14 (finding that a reasonable investor would consider the payment of kickbacks an important fact in the decision to buy or sell securities); *Stephens Inc.*, 68 SEC Docket at 1864 (stating that secret kickback arrangements are material because "they are always corrupting"); *First Fid.*, 61 SEC Docket at 76 (stating that secret payments to agent pursuant to kickback scheme were material "because such arrangements and payments could compromise the independence and judgment of these agents and distort the underwriter selection process").

The evidence also established that Riordan acted with scienter,[47] described as "a mental state embracing intent to deceive, manipulate, or defraud."[48] Riordan intentionally made efforts to conceal the kickback scheme and avoid detection by authorities. For example, Riordan paid Montoya kickbacks in response to code words, such as "help me out" and "green tree"; Riordan met Montoya surreptitiously, often in restaurant restrooms, to pay kickbacks; Riordan used cash as the method of payment; and Riordan never spoke about the kickbacks or his secret payment arrangement with Montoya. In addition, Riordan personally benefitted from the kickback scheme, earning hundreds of thousands of dollars in commissions and bonuses from NMSTO business during the relevant period. Riordan thus had a pecuniary motive for engaging in the kickback scheme, further circumstantial evidence of his scienter.[49]

We therefore conclude that Riordan's secret cash payments to Montoya in exchange for NMSTO securities transactions constituted a scheme to defraud and course of business that operated as a fraud or deceit on the State and other participants in the NMSTO's bidding process.[50] As a result of this conduct, we find that Riordan willfully violated Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5.[51]

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[47] *See Aaron v. SEC*, 446 U.S. 680, 685, 697 & 701-02 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Scienter is not required to prove a violation of Securities Act Sections 17(a)(2) and 17(a)(3); instead, a showing of negligence is sufficient. *Aaron*, 446 U.S. at 697 & 701-02; *SEC v. Wolfson*, 539 F.3d 1249, 1256-57 (10th Cir. 2008); *Weiss v. SEC*, 468 F.3d 849, 855 (D.C. Cir. 2006).

[48] *Ernst & Ernst*, 425 U.S. at 193 n.12. Proof of scienter may be demonstrated by circumstantial evidence. *Herman & Maclean v. Huddleston*, 459 U.S. 375, 390-91 n.30 (1983); *Valicenti Advisory Servs., Inc. v. SEC*, 198 F.3d 62, 65 (2d Cir. 1999).

[49] *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 325 (2007) (stating that "motive can be a relevant consideration, and personal financial gain may weigh heavily in favor of a scienter inference").

[50] *See, e.g., Savino*, 2006 WL 375074, at *13 (securities sales representative engaged in scheme to defraud insurance company by giving kickbacks to bond trader in exchange for business and favorable bond trades); *Santos*, 355 F. Supp. 2d at 919 (allegations that registered representatives participated in city treasurer's illegal scheme to offer city's investment business in exchange for cash payments and campaign donations stated cause of action under Exchange Act Rule 10b-5).

[51] A willful violation of the securities laws means the intentional commission of an act that constitutes the violation; there is no requirement that the actor must be aware that he is violating any statutes or regulations. *See Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000).

B. Riordan Raises Numerous Arguments Against Antifraud Liability.

1. Montoya fabricated his story that Riordan paid him kickbacks.

Riordan argues that, upon Montoya's arrest in September 2005, Montoya fabricated a story that Riordan secretly paid him kickbacks in exchange for NMSTO securities transactions. Law enforcement authorities first learned of kickback schemes and corruption in the NMSTO in December 2003, not through Montoya, but through Sandoval. By April 2005, five months before Montoya knew that he was under investigation, Sandoval had told the FBI that Montoya had informed Sandoval, while they were both working at the NMSTO, that he was receiving cash payments from Riordan in return for NMSTO securities transactions. As the FBI investigation continued, in August 2004, Garcia implicated Riordan in "kickbacks and illegal securities activity." The various kickback schemes did not become public until at least September 2005 when Montoya was arrested. Montoya mentioned the kickback scheme with Riordan upon his arrest and in his first interview with the FBI in September 2005. Montoya's account to the FBI in 2005 was consistent with Sandoval's and Garcia's earlier statements to the FBI.

Riordan offers no explanation for how Montoya could have fabricated a story that, unbeknownst to Montoya, informants Sandoval and Garcia had already told to the FBI. Riordan does not claim that Sandoval and Garcia fabricated their stories to the FBI, nor does he claim or provide any evidence of coordination among Montoya, Sandoval, and Garcia related to the FBI's investigation.[52]

2. The law judge should not have believed Montoya's testimony.

a. Riordan accuses the law judge of accepting Montoya's hearing testimony and FBI statements as "gospel, sorting through his various inconsistent renditions of the kickback story" and "obvious lies" "to find 'facts' to support this conclusion." In her initial decision, the law judge stated, in relevant part, "Based on my observation of his demeanor, how he responded to questions, and comparing his testimony with the other evidence in the record, I find Montoya to be credible. He was confused or lacking in information on some details, but, in my judgment, he was consistent and candid in his responses." As we have stated previously, a law judge's credibility findings "are entitled to considerable weight and deference because they are based on hearing the witnesses' testimony and observing their demeanor."[53] Those findings may be

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[52] As noted previously, both Sandoval and Garcia, as part of their cooperation with the FBI, were taping conversations that they had with Montoya before Montoya's arrest.

[53] *Schield Mgmt. Co.,* Exchange Act Rel. No. 53201 (Jan. 31, 2006), 87 SEC Docket 848, 861 n.42; *see also Dolphin and Bradbury, Inc.,* Exchange Act Rel. No. 54143 (July 13, 2006), 88 SEC Docket 1298, 1308 n.33, *aff'd,* 512 F.3d 634 (D.C. Cir. 2008).

overcome only when there is substantial evidence in the record for doing so.[54] Riordan has not shown, nor do we find, substantial evidence contradicting the law judge's credibility findings in favor of Montoya.

b. Riordan argues that Montoya "provided conflicting statements to the FBI and equivocal, inconsistent testimony at the hearing regarding the nature, manner, and amounts of the purported kickbacks." Montoya's entire story has remained consistent and unequivocal since his arrest. Montoya recounted the same version of events over the course of four FBI interviews between September 2005 and February 2006, Vigil's two criminal trials in 2006, and the December 2007 hearing in this administrative proceeding. At no time did Montoya change his story that Riordan paid him secret cash kickbacks in exchange for agency securities transactions from the NMSTO. Moreover, Montoya's version of the relevant events was consistent with, and corroborated by, the other evidence at the hearing, including Riordan's own tape recorded conversations wherein Montoya demanded kickbacks from Riordan and, in response, Riordan agreed to meet with him.

c. Riordan argues that "[t]he only testimony Montoya gave that was consistent -- that he never got kickbacks from Mr. Riordan on sales by the State -- was rejected by the [law judge] who imagined that, because he was so greedy, Montoya must have gotten kickbacks on all the business."[55] As discussed, Montoya's testimony that he did not receive kickbacks from Riordan on sales transactions was equivocal. Montoya qualified that portion of his testimony by stating that it was his "best guess" and that he was "confused." In addition, that portion of Montoya's testimony was contradicted by other evidence showing that Riordan received preferential treatment on his sales bids and, in fact, paid kickbacks on sales transactions. For example, in October 2002, Montoya awarded Riordan four sales transactions when Riordan had the worst bids. In exchange for the award of those sales (and one purchase), Riordan met Montoya at the Kicks 66 gas station and paid him kickbacks.

It has been held that a finder of fact is "free to believe part of [a witness's] testimony and to reject other parts."[56] In light of Montoya's confusion and the countervailing evidence, the law

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[54] *See, e.g., Laurie Jones Canady*, 54 S.E.C. 65, 78 (1999), *petition denied*, 230 F.3d 362 (D.C. Cir. 2000); *Anthony Tricarico*, 51 S.E.C. 457, 460 (1993).

[55] Riordan accuses the law judge of imagining that Montoya received kickbacks on all transactions because she found him to be "so greedy." During his testimony, Montoya readily admitted, "I was greedy."

[56] *Vector Pipelines, L.P. v. 68.55 Acres of Land*, 157 F. Supp. 2d 949, 953 (N.D. Ill. 2001) (internal quotations and citation omitted); *see also, e.g., Tricarico*, 51 S.E.C. at 461 (upholding credibility determination despite alleged inconsistencies in witness's testimony). As one court of appeals has observed, "[a]nyone who has ever tried a case or presided as a judge at a

(continued...)

judge properly could reject Montoya's testimony that Riordan did not pay him kickbacks on sales, while accepting the rest of his testimony as true. Our independent review of the facts supports the finding that Riordan paid Montoya kickbacks on both sales and purchases of agency securities.[57]

d. In Riordan's brief on appeal and at oral argument, Riordan's counsel seemed to concede that Riordan was given a "last look," but argued that this practice was not prohibited by the Investment Policy and that "there was nothing improper about" the practice. While the Investment Policy may not have expressly prohibited the use of a "last look," the evidence established that it was a bid rigging device that Montoya used to ensure that Riordan won bids. As Montoya testified, the term "last look" was merely a shorthand description of his instructions to Sandoval to award transactions to Riordan, in return for illegal kickbacks, by whatever means necessary. As such, the use of a "last look" was inconsistent with the competitive bidding process mandated by the Investment Policy. Even Riordan's expert considered the use of a "last look" to be "inappropriate."

e. Riordan argues that Montoya's description of the kickback scheme with Riordan did not fit Montoya's usual mode of operation regarding kickbacks. For example, Riordan claims that Montoya typically used Sandoval and Garcia as intermediaries to collect kickbacks, but that "neither Sandoval nor Garcia ever collected money from" him. Tucker's testimony refutes this argument and indicates that Montoya's kickback scheme with Tucker operated in a similar way to Montoya's kickback scheme with Riordan. As noted previously, Tucker testified that he paid cash kickbacks to Montoya after Montoya would ask Tucker to "help [him] out"; Tucker was awarded NMSTO agency securities transactions in exchange for cash; Montoya would meet Tucker in person at restaurants to collect the payment;[58] and Tucker would give Montoya approximately $300 or $500 per transaction.

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56 (...continued)
trial knows that witnesses are prone to fudge, to fumble, to misspeak, to misstate, to exaggerate. If any such pratfall warranted disbelieving a witness's entire testimony, few trials would get all the way to judgment." *Kadia v. Gonzales*, 501 F.3d 817, 821 (7th Cir. 2007).

57 Assuming that Riordan paid cash kickbacks only on purchases, and not on sales, Riordan's liability would remain unchanged. Under the antifraud provisions, it was sufficient for the Division to demonstrate that Riordan, acting with scienter, engaged in a deceptive scheme to make secret cash payments to Montoya in exchange for securities transactions generally from the NMSTO. Riordan has not pointed to any cases, and we have found none, requiring the Division to link each kickback to a specific securities transaction.

58 Montoya testified that, like Riordan, he felt comfortable with Tucker, so he did not need an intermediary to collect kickbacks from Tucker. According to Tucker, on one occasion, he paid a kickback to Sandoval, rather than to Montoya, because Montoya "did not want to be met." However, Tucker stated that he told Montoya that he would never do that again.

3. The law judge should have believed Riordan's testimony.

a. Riordan argues that the law judge erred when she stated that "[t]he only evidence that kickbacks did not occur [was] Riordan's denial, and Riordan [was] not credible." Apart from his own self-serving denial in this proceeding, Riordan failed to contradict the evidence that he was awarded NMSTO agency securities transactions through a rigged bidding process and paid secret cash kickbacks to Montoya in exchange for those transactions. As noted previously, Riordan listed Beserra, Garcia, Sandoval, and Sanchez as witnesses with first-hand knowledge of the relevant facts. However, Riordan did not call any of these witnesses at the hearing to support his version of events.[59]

Moreover, Riordan's tape recordings of his conversations with Montoya demonstrated that he knew how, and had the means, to document his own innocence by taping himself telling Montoya that he would not pay kickbacks in exchange for NMSTO securities transactions. However, Riordan admitted that he never taped himself saying those words.

The tape recordings also demonstrated that Riordan knew, at least since 1997, when the recordings were made, that Montoya was a corrupt public official who demanded the payment of kickbacks in exchange for securities transactions from the NMSTO. Despite this knowledge, Riordan continued to meet with Montoya, engaged in substantial NMSTO business with him for several years, and made hundreds of thousands of dollars in commissions from that business. As late as December 2002, Riordan admitted that he willingly agreed to meet Montoya at a gas station, even though he knew that Montoya was "very, very mad" at him and was demanding payment for the October 2002 transactions. While Riordan claimed that nothing more than an "exchange of words" took place, the law judge credited Montoya's testimony that Riordan paid him kickbacks for the five October 2002 transactions.

Riordan's conduct in continuing to do business with Montoya, despite his knowledge that Montoya was, in his words, "crooked," and in failing to notify the appropriate authorities of the kickback scheme and corruption in the NMSTO, is further evidence that Riordan, acting with scienter, paid Montoya secret cash kickbacks in exchange for NMSTO securities transactions.

b. Riordan argues that "the [initial decision] claims that Mr. Riordan is not credible, but the reasons it gives are without merit." The law judge stated that she based her adverse credibility finding on the "many discrepancies" in the record. For example, the law judge found

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[59] At oral argument, Riordan's counsel cited the absence of any cancelled checks in the record as support for his contention that the Division's case was weak. Riordan conceded, however, that he made payments to Montoya, whether in cash or by check, as political contributions early in their relationship. Neither side introduced any checks. We do not consider the absence of such checks significant. Montoya's credited testimony was that, for most of the period at issue, the improper payments were in cash.

that, at the hearing, Riordan gave "two completely different explanations as to why he had not produced the tape recorded conversations in response to a July 2007 Division subpoena." Riordan does not dispute that his two explanations were contradictory.

The law judge also found that "Riordan's explanation of obtaining a Las Vegas hotel room for Montoya because Las Vegas was crowded due to the Super Bowl was false because the Super Bowl occurred" almost a month earlier.[60] Indeed, when confronted with the actual date of the Super Bowl on cross-examination, Riordan admitted that he "made a wrong assumption." In an attempt to minimize this damaging evidence, Riordan argues that his "faulty assumption on an irrelevant issue is not the type of testimony that should carry any weight." Riordan's explanation for the hotel room payment was relevant information because it bore upon his credibility.

The law judge further found that Riordan did not inform his forensic accounting expert, who reviewed his finances, of his wife's $100,000 line of credit, and that he failed to reveal to Division staff a 2002 land sale for $1.3 million.[61] At the hearing, Riordan admitted that he failed to inform his forensic accounting expert about the $100,000 line of credit. Riordan also admitted that he failed to inform Division staff of the 2002 land sale during his investigative testimony.[62]

4. The law judge should have believed Riordan's expert and not the Division's expert.

a. Riordan argues that Division expert McKinney's opinion of the NMSTO's bidding process was entitled to no weight.[63] Riordan offers no support for this argument and no evidence to contradict McKinney's testimony. McKinney opined that the NMSTO's bidding process was not competitive. He analyzed thirteen NMSTO transactions with Riordan in 2001 and 2002, highlighting examples of noncompetitive bids. As noted above, Perrone did not disagree with

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60 *See supra* note 28.

61 In 2002, Riordan sold real estate he and others purchased for $225,000 to the Pueblo of Sandia (a Native American tribe located in central New Mexico) for $1.3 million (and a $1.8 million charitable contribution to the Pueblo).

62 Riordan testified that he did not inform Division staff of the 2002 land sale because he did not think it was "pertinent."

63 We have stated that, "[w]hile an expert's testimony may properly be given substantial weight by the Commission, it has the duty to make its independent analyses and findings." *West Penn Elect. Co.*, 29 S.E.C. 685, 693 n.7 (1949). In resolving the issues raised in this case, "we have appraised and given such weight to the expert testimony as we consider is indicated by the relevant facts in the record." *Ira Weiss*, Securities Act Rel. No. 8641 (Dec. 2, 2005), 86 SEC Docket 2588, 2597 n.21, *petition denied*, 468 F.3d 849 (D.C. Cir. 2006).

McKinney's analysis, stating that it was "reasonable and correct." In fact, Perrone admitted that he, too, found irregularities in the bidding.

b. Riordan complains that McKinney focused only on transactions in 2001 and 2002. Riordan gives no reason why the time frame considered by McKinney should be viewed as affecting the validity of his opinion. Further, Sandoval testified that this was the only period during which records were kept.

c. Riordan complains that McKinney did not read the Investment Policy or Order Instituting Proceeedings, but fails to explain how this affected the validity of McKinney's opinion. McKinney's opinion assumed that competitive bidding was required. That requirement was set forth in the Investment Policy, which stated that all securities transactions were to be conducted pursuant to a "formal and competitive" process. McKinney's opinion that the bidding was not competitive, but rigged, was supported by ample evidence, which Riordan has not contradicted.

d. Riordan complains that the law judge erred in crediting McKinney's statement that it was unlikely that First Union and Riordan would have been so consistently successful absent the existence of the kickback scheme. Riordan argues that, if McKinney had read the Investment Policy, which stated that "[s]ecurities broker/dealers with offices in New Mexico [would] be given priority when possible over out-of-state dealers," he would have expected a firm like Riordan's to be "consistently successful" in the bidding process for NMSTO securities transactions. While it is true that Riordan, as a local broker, was entitled to "priority when possible," the evidence established that Montoya gave Riordan an unfair advantage by, among other things, telling him what his competitors had bid so he could better his own bid, allowing him to place bids on securities with longer settlement or maturity dates than his competitors, and awarding him transactions when his bids were not the best bids.[64]

e. Riordan argues that Perrone disagreed with McKinney and that the law judge erroneously concluded that Perrone did not. The law judge specifically questioned Perrone on the issue of whether he disagreed with McKinney. Perrone testified that, although he thought that "some of [McKinney's] beliefs" were "wrong,"[65] he could not conclude that McKinney's analysis of the trades was wrong. Based on our independent review, we accord substantial weight to McKinney's analysis, as it comports with the evidence in the record.

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64 As stated earlier, Abbey testified that, during his employment at the NMSTO, Riordan generally was not successful on competitive bids even though he was a local broker entitled to a "priority."

65 For example, Perrone testified that McKinney was wrong in stating that "all trades [were] done in 30 seconds."

5. The law judge relied on hearsay evidence.

Riordan argues that the law judge erred in relying on hearsay statements made by Sandoval and Garcia in FBI 302s.[66] Hearsay evidence is admissible in our administrative proceedings and "can provide the basis for findings of violation, regardless of whether the declarants testify."[67] In addition, "hearsay statements may be admitted in evidence and, in an appropriate case, may form the basis for findings of fact."[68] In evaluating the probative value and reliability of hearsay evidence, as well as the fairness of its use, we consider a number of factors, including "the possible bias of the declarant, the type of hearsay at issue, whether the statements are signed and sworn to rather than anonymous, oral, or unsworn, whether the statements are contradicted by direct testimony, whether the declarant was available to testify, and whether the hearsay is corroborated."[69]

The hearsay statements made by Sandoval and Garcia in the FBI 302s satisfied a number of these factors. The evidence was probative because it related to Riordan's involvement in the kickback scheme. The evidence also appeared to be reliable, as there was no evidence that Sandoval and Garcia were biased or had an incentive to falsify their statements. Both Sandoval and Garcia were on Riordan's witness list, but Riordan did not call them as witnesses in his case-in-chief. Sandoval, but not Garcia, testified at the hearing as a Division witness, and Riordan had the opportunity to cross-examine Sandoval. Sandoval's statements in the FBI 302s were, in all material respects, consistent with his testimony, and he confirmed their contents at the hearing.[70] Furthermore, Sandoval's and Garcia's statements, although not signed or sworn to, were identified by Agent Marcus McCaskill, one of the two lead agents in the FBI's NMSTO investigation, who was also subject to cross-examination by Riordan, and were corroborated by other, nonhearsay evidence. Riordan did not present any evidence to contradict Sandoval's and Garcia's statements, apart from his own discredited testimony.

We conclude that the law judge did not err in admitting Sandoval's and Garcia's hearsay statements in the FBI 302s. Moreover, even if the admission of this evidence constituted error, it

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[66] "An FBI 302 is a form routinely used to memorialize an FBI interview of a witness." *United States v. Nathan*, 816 F.2d 230, 232 n.1 (6th Cir. 1987).

[67] *Scott Epstein*, Exchange Act Rel. No. 59328 (Jan. 30, 2009), 95 SEC Docket 13833, 13853-54, *appeal filed*, No. 09-1550 (3d Cir. Feb. 24, 2009).

[68] *Id.* (internal quotations and citation omitted).

[69] *Id.*

[70] *See Carlton Wade Fleming, Jr.*, 52 S.E.C. 409, 411 n.8 (1995) (finding hearsay evidence to be sufficiently reliable and probative where it was consistent with other nonhearsay evidence).

was harmless.[71] As demonstrated, there was ample evidence in the record, independent of the FBI 302s, to support our findings of antifraud violations.[72]

6. The law judge impermissibly restricted Riordan's proof.

a. Riordan argues that the law judge erred in precluding him from cross-examining Montoya (and testifying in his own defense) about the NMSTO's investment in certain mutual fund transactions which would have paid Montoya kickbacks after Montoya left office. According to Riordan, Montoya was angry with him because he (purportedly) advised Montoya's successor, Vigil, to cancel those post-term mutual fund transactions, and falsely named him in the kickback scheme at issue here involving agency securities transactions.

Our Rule of Practice 320 provides that "the hearing officer may receive relevant evidence and shall exclude all evidence that is irrelevant, immaterial or unduly repetitious."[73] We have stated that law judges have "broad discretion" in determining whether to admit or exclude evidence.[74]

The law judge refused to allow questioning into the post-term mutual fund transactions because those transactions involved a different scheme from the scheme charged in the Order Instituting Proceedings, and so were irrelevant to the allegations against Riordan. In addition,

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71 *See U.S. Assocs., Inc.*, 51 S.E.C. 805, 812 & n.24 (1993) (noting that finding of harmless error may overcome procedural objections).

72 Riordan argues that the law judge relied on "gross hearsay," referring to Division Exhibits 29 (documents from the State Legislature's Legislative Finance Committee), 30 (budget analyses of the NMSTO prepared by that Committee), and 84 (an October 2002 Albuquerque Journal article reporting that a State Board of Finance member was concerned that, between February and September 2002, First Union (Riordan) and Southwest Securities (Tucker) received 90% of commissions for buying bonds issued by federal government agencies for the NMSTO).

As discussed, hearsay evidence is admissible in our administrative proceedings. Division Exhibits 29 and 30 bore upon the preferential treatment accorded to Riordan (and Tucker) and appeared to be reliable, having been corroborated by Abbey's testimony at the hearing. Riordan did not object to the admission of Division Exhibit 84 before the law judge, and therefore waived his argument regarding this exhibit on appeal. In all events, our independent review of the record confirms that Riordan received an unfair advantage in the NMSTO bidding process.

73 17 C.F.R. § 201.320.

74 *Scott G. Monson*, Investment Company Act Rel. No. 28323 (June 30, 2008), 93 SEC Docket 7517, 7526 n.27 (internal quotations and citation omitted).

Montoya testified that he had no knowledge of Riordan's purported role in unraveling the post-term mutual fund transactions. As discussed above, the FBI was aware of the kickback scheme involving agency securities transactions before it arrested and interviewed Montoya, thereby undermining Riordan's claim that Montoya fabricated his testimony. Furthermore, FBI Agent McCaskill testified that Riordan's name was never mentioned in connection with the scheme involving post-term mutual fund transactions. We conclude that the law judge did not abuse her discretion in precluding this line of questioning, nor was Riordan prejudiced thereby. There was sufficient evidence in the record establishing Riordan's participation in the kickback scheme involving agency securities transactions.

b. Riordan argues that the law judge erred in refusing to allow Gary Bland, who served as New Mexico State Investment Officer beginning in 2003, to testify as a witness in his defense. In a prehearing submission, Riordan explained that, among other topics, Bland would testify with respect to the NMSTO's investment requirements, "the legality of a 'last look' . . . and why this did not violate any law, regulation or rule of the State of New Mexico nor the SEC," and Montoya's "inappropriate purchase of mutual funds" at the end of his term.

The Division objected to Bland testifying because he was, in effect, being offered to give expert testimony, and because Riordan did not file an expert report, as required by the law judge's scheduling order. In his brief on appeal, Riordan argues that Bland was not offered as an expert, but that his testimony would explain "industry practices, the State of New Mexico's practices" and relate to "Montoya's motive and bias against Mr. Riordan when Mr. Riordan single-handedly caused Mr. Montoya's successor [Vigil] to sell ill-advised mutual funds, which had the consequence of denying a future stream of illegal kickback funds accruing to Mr. Montoya after he left office."

At the hearing, the law judge excluded Bland's testimony because she found that it amounted to expert testimony involving "his expertise about industry practice, the State of New Mexico's practices," and because Riordan failed to file an expert report, in contravention of her scheduling order. The law judge also found that, to the extent that Bland would testify about Montoya's "motive and bias against Mr. Riordan" for Riordan's alleged role in unraveling the post-term kickback scheme involving mutual funds, such testimony was irrelevant.

We find that the law judge acted within her discretion in excluding Bland's testimony. Riordan failed to comply with the law judge's scheduling order for filing expert reports. While Riordan appears now to argue that Bland was offered merely as a fact witness, the record shows that Bland did not become employed by the NMSTO until 2003, which was after the relevant period. As a result, the law judge did not err in determining that Bland's testimony regarding any factual matters would be irrelevant.[75] As discussed above, the law judge's determination to

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75 *See* 17 C.F.R. § 201.320 (authorizing hearing officers to "exclude all evidence that is irrelevant, immaterial or unduly repetitious").

exclude testimony regarding an alleged post-term kickback scheme involving mutual funds was proper.

c. Riordan argues that the law judge erred when she "took into account [his] invocation of his Fifth Amendment privilege [against self-incrimination] in reaching her decision." Riordan invoked the Fifth Amendment during investigative testimony and refused to answer questions about Montoya, Vigil, transactions with the NMSTO, and why either Montoya or Sandoval might have been motivated to lie about Riordan's involvement in the kickback scheme. The Division moved *in limine* to preclude Riordan from testifying at the hearing due to his invocation of the Fifth Amendment during its investigation of this matter. The law judge denied the Division's motion and allowed Riordan to take the stand.

Our proceedings are civil in nature, and an adverse inference may be drawn in such proceedings from a respondent's invocation of his Fifth Amendment privilege against self-incrimination.[76] The fact finder has discretion in determining whether an adverse inference is proper.[77] "Due consideration should be given to 'the nature of the proceeding, how and when the privilege was invoked, and the potential harm or prejudice to opposing parties.'" [78] Because the assertion of the Fifth Amendment is an effective way to hinder discovery, the fact finder "'must be especially alert to the danger that the litigant might have invoked the privilege primarily to . . .

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76 *Strathmore Sec., Inc.*, 43 S.E.C. 575, 590 (1967); *see, e.g.*, *SEC v. DiBella*, Civ. No. 3:04 CV 1342(EBB), 2007 WL 1395105, at *3 (D. Conn. May 8, 2007) (allowing adverse inference instruction to jury based on defendant's invocation of Fifth Amendment privilege during three SEC investigative interviews; stating that an SEC investigative interview "is not a criminal proceeding, [and] an adverse inference is admissible evidence so long as it is not substantially outweighed by the danger of unfair prejudice"); *SEC v. Herman*, No. 00 Civ. 5575, , 2004 WL 964104, at *7 (S.D.N.Y. May 5, 2004) (drawing negative inference where defendants invoked Fifth Amendment privilege during investigative testimony but later testified during deposition); *SEC v. Cassano*, No. 99 Civ. 3822, 2000 WL 1512617, at *2 n.1 (S.D.N.Y. Oct. 11, 2004) (finding adverse inference appropriate where defendants asserted Fifth Amendment privilege during investigative testimony but later waived privilege).

77 *Int'l Union (UAW) v. NLRB.*, 459 F.2d 1329, 1339 (D.C. Cir. 1972); *SEC v. Gilbert*, 79 F.R.D. 683, 685 n.3 (S.D.N.Y. 1978); *see, e.g.*, *Daniel R. Lehl*, 55 S.E.C. 843, 861 n.33 (2002) (stating that "[a] trier of fact in a civil proceeding may draw adverse inferences from a respondent's refusal to testify," and that, "where appropriate," the Commission may draw such inferences).

78 *DiBella*, 2007 WL 1395105, at *3 (quoting *United States v. Certain Real Prop. And Premises Known as: 4003-4005 5th Ave., Brooklyn, NY*, 55 F.3d 78, 84 (2d Cir. 1995)).

gain an unfair strategic advantage over opposing parties.'"[79] A litigant may be barred from testifying later about matters previously hidden from discovery through improper invocation of the Fifth Amendment.[80]

While, at the hearing, the law judge observed that she found "relevant" Riordan's invocation of the Fifth Amendment and considered it permissible to draw an adverse inference against Riordan, her findings against Riordan do not appear to have been based on any such inference. Although the law judge noted in her decision that Riordan had invoked the privilege during the investigation that led to this proceeding, she also acknowledged Riordan's argument that no adverse inference should be drawn from his assertion of the privilege because he believed at the time that he was a target of a criminal investigation as a result of his political party affiliation. The law judge made no other mention of Riordan's Fifth Amendment invocation in her decision. A fair reading of her decision suggests that the law judge determined that it was unnecessary to draw an adverse inference to support her findings, given what she described as the "persuasive" evidence against Riordan. We also consider the evidence against Riordan to be persuasive and more than sufficient to support findings of violations, without regard to any adverse inference.

d. Riordan further argues that the law judge took a "get even approach" to the case and tried to "get" him because he "escaped criminal prosecution" for "paying kickbacks . . . that resulted in criminal convictions for [Montoya]." Riordan seems to be claiming that the law judge was biased against him. Our review of the record discloses no bias or other improper conduct. The fact that the law judge did not rule in Riordan's favor does not support a finding of bias. As we have stated previously, "adverse rulings, by themselves, generally do not establish improper bias."[81] In any event, we have considered all of the relevant evidence and made an independent judgment of liability based on that evidence. Our *de novo* review cures whatever bias, if any, may have existed.[82]

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79 *Id.*

80 *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 855 (S.D.N.Y. 1997).

81 *Mitchell M. Maynard*, Investment Advisers Act Rel. No. 2875 (May 15, 2009), 95 SEC Docket 16844, 16856 (internal quotations and citation omitted).

82 *See, e.g., Robert Bruce Orkin*, 51 S.E.C. 336, 344 (1993) (stating that "our *de novo* review of this matter cures whatever bias or disregard of precedent or evidence, if any, that may have existed below"), *aff'd*, 31 F.3d 1056 (11th Cir. 1994).

7. Riordan's "after-the-fact payments" were not "in connection with" his legitimate securities transactions with the NMSTO.

Exchange Act Section 10(b) requires that the fraud be "in connection with" the purchase or sale of securities.[83] In *SEC v. Zandford*,[84] the U.S. Supreme Court held that the "in connection with" requirement is met if the "fraudulent scheme" and securities transaction "coincide."[85]

Riordan argues that "the [initial decision] has not explained how after-the-fact payments by Mr. Riordan in whatever amount he chose could have been 'in connection with' the legitimate securities transactions that had already been completed." The Supreme Court rejected a similar argument in *Zandford*. There, the respondent allegedly sold securities belonging to a client for the purpose of transferring the proceeds to an account that he controlled.[86] The respondent claimed that, since the securities sales were completely lawful and the alleged fraud took place after the securities were sold, the fraud was separate from and independent of the securities sales.[87] The Supreme Court disagreed, finding that, even though the securities sales were lawful, they were made to effectuate the fraud.[88] The fraud coincided with the securities sales, and thus was "in connection with" the securities sales.[89] Consistent with *Zandford*, Riordan's payment of secret cash kickbacks clearly "coincided" with, and were a condition of his receiving orders for, the NMSTO's purchases and sales of agency securities, and therefore satisfied the "in connection with" requirement.[90]

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[83] The Supreme Court has adopted a broad reading of Exchange Act Section 10(b)'s "in connection with" requirement. *See, e.g., Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 85 (2006); *SEC v. Zandford*, 535 U.S. 813, 819 (2002); *United States v. Naftalin*, 441 U.S. 768, 773 (1979).

[84] 535 U.S. 819 (2002).

[85] *Id.* at 819 & 825; *see also, e.g., Santos*, 355 F. Supp. 2d at 920.

[86] 535 U.S. at 815-16.

[87] *Id.* at 820.

[88] *Id.*

[89] *Id.* at 825.

[90] *See, e.g., Santos*, 355 F. Supp. 2d at 920 (alleged scheme by which registered representatives gave city treasurer cash payments and campaign donations in exchange for city's investment business was "in connection with" the purchase or sale of securities); *Rudi*, 902 F. Supp. at 456-57 (undisclosed scheme through which financial adviser to local government

(continued...)

8. There was no proof of actual harm.

Riordan suggests, without citation to any authority, that the fraudulent scheme had to result in "actual harm to the entity on the other side of the transaction." Riordan's argument misstates the law because, unlike a plaintiff in a private damages action, the Division need not demonstrate actual harm or losses to investors.[91] Riordan's argument also misstates the facts because the record showed that, contrary to the Investment Policy, Riordan was awarded NMSTO agency securities transactions when he did not have the best bids. A prime example involved the four sale transactions that Riordan won in October 2002 when his bids were the worst bids among his competitors. Riordan cannot reasonably claim an absence of harm to the citizens of New Mexico in view of the evidence that the NMSTO engaged in agency securities transactions which did not have the most favorable economic terms for the State. Nor can he reasonably claim an absence of harm to other market participants given the evidence that his competitors' bids were routinely denied through a rigged bidding process.

IV.

A. Statute Of Limitations.

Riordan argues that the five-year statute of limitations set forth in 28 U.S.C. § 2462 bars the proceeding and the sanctions imposed against him.[92] Section 2462 provides, in pertinent part, that "any proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise," must be commenced "within five years from the date when the claim first accrued."[93] The violations in this case occurred from approximately 1996 through December 2002. The Commission instituted this administrative proceeding on September 25, 2007. Five of Riordan's approximately eighty agency securities transactions with the NMSTO occurred in October 2002, and therefore fell within the five-year period before the institution of this proceeding.

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90 (...continued)
authority received kickbacks from lead underwriter of bond issue for government authority constituted fraud "in connection with" the sale of bonds).

91 *See, e.g.*, *Graham v. SEC*, 222 F.3d 994, 1001 n.15 (D.C. Cir. 2000); *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1363 n.4 (9th Cir. 1993); *Schellenbach v. SEC*, 989 F.2d 907, 913 (7th Cir. 1993); *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985); *Savino*, 2006 WL 375074, at *15.

92 *See Johnson v. SEC*, 87 F.3d 484, 492 (D.C. Cir. 1996) (holding that five-year statute of limitation period in 28 U.S.C. § 2462 applied to certain Commission administrative proceedings).

93 28 U.S.C. § 2462.

Accordingly, Riordan committed willful violations within the limitations period, and this proceeding is not time-barred.

We may consider conduct occurring before September 25, 2002, to establish such matters as Riordan's course of conduct, motive, intent, or knowledge in committing violations that are within the limitations period.[94] We may also consider such conduct in deciding whether to impose a cease-and-desist or disgorgement order because such an order operates prospectively and is not subject to Section 2462.[95]

We need not consider Riordan's conduct occurring before September 25, 2002, in determining whether to impose a bar or civil money penalties. Rather, we have based those sanctions exclusively on Riordan's conduct occurring during the five-year period preceding the OIP's issuance.[96]

B. Bar From Association.

Exchange Act Section 15(b)(6) authorizes us to censure, place limitations on, suspend, or bar a person associated with a broker or dealer if we determine that the person has, among other things, willfully violated the federal securities laws and it is in the public interest to do so.[97] In determining what sanction is in the public interest, we consider the factors in *Steadman v. SEC*,[98] which include the egregiousness of a respondent's actions, the degree of scienter involved, the

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[94] *See, e.g., Joseph J. Barbato*, 53 S.E.C. 1259, 1278 & n.26 (1999); *Sharon M. Graham*, 53 S.E.C. 1072, 1089 n.47 (1998), *aff'd*, 222 F.3d 994 (D.C. Cir. 2000); *Terry T. Steen*, 53 S.E.C. 618, 624 (1998).

[95] *See Terence Michael Coxon*, 56 S.E.C. 934, 966 n.60 (2003) (stating, "[b]ecause a cease and desist order is forward-looking, . . . Section 2462 does not apply"; noting that such an order "requires only that Respondents obey the law, which they must do in any event, and is designed to ameliorate the risk of similar violations occurring in the future"), *aff'd*, 137 Fed Appx. 975 (9th Cir. 2005) (unpublished).

[96] Had we chosen to do so, we could, for example, have considered Riordan's pre-September 25, 2002, conduct pursuant to the fraudulent concealment doctrine. We find that, due to the self-concealing nature of Riordan's kickback scheme, the fraudulent concealment doctrine applied and equitably tolled the statute of limitations period until no earlier than September 2005 when Montoya's arrest became public. *See, e.g., SEC v. Koenig*, 557 F.3d 736, 739-40 (7th Cir. 2009) (fraudulent concealment doctrine applied in Commission enforcement proceeding to equitably toll 28 U.S.C. § 2462's five-year statute of limitations period).

[97] 15 U.S.C. § 78*o*(b)(6).

[98] 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981).

isolated or recurrent nature of the infraction, the recognition of the wrongful nature of the conduct, the sincerity of any assurances against future violations, and the likelihood that the respondent's occupation will present opportunities for future violations.[99] "[N]o one factor is dispositive."[100] As we have previously recognized, "conduct [that] violates the antifraud provisions is especially serious and subject to the severest sanctions."[101]

Riordan challenges the law judge's determination to bar him from associating with any broker or dealer. He argues that the sanction of a bar is "unwarranted and unjust" and "reflect[s] the [law judge]'s blind acceptance of, at best, flimsy and contradictory evidence." We find, as did the law judge, that the public interest factors weigh in favor of barring Riordan. Riordan's actions in paying kickbacks to Montoya in exchange for agency securities transactions from the NMSTO were egregious. We have stated that kickback arrangements are "always corrupting."[102] Riordan's payment of kickbacks to Montoya contributed to the corruption of a public official. Furthermore, the kickback agreement "cast doubt on the integrity of the [NMSTO's bidding] process."[103]

Riordan acted with a high degree of scienter. Riordan knew that Montoya demanded kickbacks in exchange for securities transactions from the NMSTO. Riordan also knew that if he paid kickbacks to Montoya he would obtain a stream of securities transactions from the NMSTO. Riordan further knew to conceal his fraudulent arrangement with Montoya and avoid detection by law enforcement authorities.

Riordan's post-September 2002 conduct involved five transactions, including four where he submitted the worst bids. He has not offered assurances against future violations, nor has he recognized that he committed serious antifraud violations.[104] While Riordan contends that his retirement from Wachovia in 2007 renders a bar inappropriate, he has not given assurances that he

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[99] *Id.*

[100] *Conrad P. Seghers,* Advisers Act Rel. No. 2656 (Sept. 26, 2007), 91 SEC Docket 2293, 2298, *petition denied,* 548 F.3d 129 (D.C. Cir. 2008).

[101] *Marshall E. Melton*, 56 S.E.C. 695, 713 (2003).

[102] *Stephens Inc.*, 68 SEC Docket at 1864 (quoting *Mosser v. Darrow*, 341 U.S. 267, 271 (1951)).

[103] *First Fid.*, 61 SEC Docket at 77.

[104] Contrary to Riordan's suggestion, his lack of a prior disciplinary history is not a mitigating factor because "securities professionals should not be rewarded for complying with the securities laws." *Maynard,* 95 SEC Docket at 16860 & n.39.

will not seek to reenter the securities industry.[105] Given the seriousness of his violations, we agree with the law judge that there was a "high likelihood" that Riordan would commit future violations if allowed to continue as an associated person.

Riordan argues that there is no need to impose a bar for deterrence purposes because there are already "numerous federal and state laws prohibiting paying kickbacks to government officials that serve as a deterrent." As this opinion illustrates, however, those laws did not deter him from paying illegal kickbacks to Montoya from 1996 to 2002.

We conclude that a bar serves the public interest and is remedial.[106] A bar also serves the goal of general deterrence and should act as a warning to others in the securities industry who might be tempted to pay kickbacks to public officials in return for securities business.[107]

C. Cease-And-Desist Order.

Securities Act Section 8A(a) and Exchange Act Section 21C authorize us to impose a cease-and-desist order if we find that any person has violated the federal securities laws or rules thereunder.[108] In determining whether a cease-and-desist order is appropriate, we look to whether

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105 *See, e.g.*, *William C. Piontek*, 57 S.E.C. 79, 96 (2003) (finding that a bar was in the public interest, even though the respondent was not currently in the securities industry, because it would require him to seek permission from a self-regulatory organization before reentering the industry, and because that organization would have the opportunity to examine any proposed employment to determine whether it was appropriate to impose necessary procedures or limitations on him); *Robert Bruce Lohmann*, 56 S.E.C. 573, 583 (2003) (finding that a bar and cease-and-desist orders were in the public interest, even though the respondent was not currently employed in the securities industry, because there were no assurances that he would not try to reenter the industry, and thereafter have the opportunity to commit future violations).

106 *See Ted Harold Westerfield*, 54 S.E.C. 25, 35 (1999) (imposing permanent bar on former associated person of broker-dealer who was convicted of, and enjoined from, violations arising out of kickback scheme with investment adviser; expressing concern that "there are opportunities to participate in kickback schemes in any capacity in the securities industry").

107 *See, e.g.*, *McCarthy v. SEC*, 406 F.3d 179, 190 (2d Cir. 2005) (noting that deterrent value is a relevant factor in deciding sanctions); *Ahmed Mohamed Soliman*, 52 S.E.C. 227, 231 n.12 (1995) (stating that selection of an appropriate sanction involves a consideration of several elements, including deterrence); *Lester Kuznetz*, 48 S.E.C. 551, 555 (1986) (noting that the sanction of a bar "serves the purpose of general deterrence").

108 15 U.S.C. §§ 77A(a), 78u-3.

there is some risk of future violations.[109] The risk of future violations required to support a cease-and-desist order is significantly less than that required for an injunction.[110] A single violation can be sufficient to indicate some risk of future violations.[111] Our finding that a violation is egregious "raises an inference that it will be repeated."[112] We also consider whether other factors demonstrate a risk of future violations, including the seriousness of the violation, the isolated or recurrent nature of the violation, whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, the respondent's state of mind, the sincerity of assurances against future violations, the recognition of the wrongfulness of the conduct, the opportunity to commit future violations, and the remedial function to be served by a cease-and-desist order in the context of any other sanction sought in the proceeding.[113] This inquiry is flexible, and no single factor is dispositive.[114]

We find that the risk of future violations is high. Riordan's conduct was serious and recurrent. Riordan engaged in fraudulent conduct spanning a seven-year period and involving a total of approximately eighty transactions. Riordan's violations were egregious and his actions reflected a high degree of scienter. Riordan profited substantially from his involvement in the kickback scheme at the expense of the citizens of New Mexico who were harmed because the State did not always receive the best prices on the agency securities it purchased and sold. In addition, other participants in the NMSTO's bidding process were harmed by Riordan's conduct, as Riordan's kickback payments to Montoya resulted in Montoya giving him preferential treatment in what was supposed to be a competitive bidding process and in selecting his bids even though they often were not the best bids.

As noted, although Riordan retired from Wachovia in 2007, he has given no assurances that he will not seek to reenter the securities industry. Imposing a cease-and-desist order will serve the remedial purpose of encouraging Riordan to take his responsibilities more seriously in the future should he be allowed to reenter the securities industry or act in a capacity that does not

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109 *KPMG Peat Marwick LLP*, 54 S.E.C. 1135, 1185 (2001), *reh'g denied*, 55 S.E.C. 1 (2001), *petition denied*, 289 F.3d 109 (D.C. Cir. 2002).

110 *Id.* at 1191.

111 *See Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004).

112 *Id.*

113 *KPMG Peat Marwick*, 54 S.E.C. at 1192.

114 *Id.*

require registration. We conclude that it is in the public interest to impose a cease-and-desist order against Riordan.[115]

D. Disgorgement.

Securities Act Section 8A(e), Exchange Act Section 21B(e), and Exchange Act Section 21C(e) authorize disgorgement, including reasonable prejudgment interest, in a cease-and-desist proceeding and a proceeding in which a civil money penalty may be imposed.[116] Disgorgement is an equitable remedy designed to deprive wrongdoers of their unjust enrichment and to deter others from similar misconduct.[117] When calculating disgorgement, "separating legal from illegal profits exactly may at times be a near-impossible task."[118] As a result, "disgorgement need only be a reasonable approximation of the profits causally connected to the violation."[119] Once the Division has shown that its disgorgement figure reasonably approximates the amount of unjust enrichment, the burden shifts to the respondent, who is "then obliged clearly to demonstrate that the

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115 Riordan argues that, by imposing an associational bar, we are precluded from also imposing a cease-and-desist order because there is no risk that he will "engage in similar future conduct" and, therefore, imposition of a cease-and-desist order will be punitive. While Riordan will be permanently barred from associating with a broker or dealer, a cease-and-desist order nonetheless serves a remedial purpose in the event that Riordan becomes involved in the securities industry in a different capacity. *See Brendan E. Murray*, Advisers Act Rel. No. 2809 (Nov. 21, 2008), 94 SEC Docket 11961, 11977 (stating that, "[a]lthough we have determined to bar Murray from association with an investment adviser or investment company, a cease-and-desist order may nonetheless serve a remedial function should Murray become active in the securities industry in another capacity").

116 15 U.S.C. §§ 77h-1(a), 78u-2(e), & 78u-3(e).

117 *Zacharias v.* SEC, 569 F.3d 471-72 (D.C. Cir. 2009) (citing *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989) and *SEC v. Bilzerian*, 29 F.3d 689, 697 (D.C. Cir. 1994), among other cases). Riordan's argument that disgorgement is not an equitable remedy and that the law judge has no equitable powers is meritless. The law is well established that disgorgement is an equitable remedy necessary to the Commission to effectuate enforcement of the federal securities laws. *See, e.g., SEC v. Cavanagh*, 445 F.3d 105, 116 (2d Cir. 2006); *SEC v. Lipson*, 278 F.3d 656, 662-63 (7th Cir. 2002); *SEC v. Pardue*, 367 F. Supp. 2d 773, 778 (E.D. Pa. 2005).

118 *First City Fin.*, 890 F.2d at 1231.

119 *Id.*

disgorgement figure was not a reasonable approximation."[120] Where disgorgement cannot be exact, the "well-established principle" is that the burden of uncertainty in calculating ill-gotten gains falls on the wrongdoer whose illegal conduct created the uncertainty.[121]

The Division requested, and the law judge ordered, Riordan to disgorge $1,017,278.78, plus prejudgment interest, consisting of $959,601.78 in commissions from 1996 to 2002 and $57,677 in bonuses from 2001 and 2002. Our review of the Division's disgorgement calculation, which was admitted into evidence as Division Exhibit 95, indicates that the $959,601.78 includes twenty transactions that do not appear to involve agency securities, but rather corporate bonds. Riordan's corporate bond transactions were not a subject of the Order Instituting Proceedings, and thus should not have been included in the disgorgement calculation. Accordingly, in our discretion, we have subtracted $78,925, representing the amount of Riordan's commissions on the twenty corporate bond transactions, from the $959,601.78, resulting in $880,676.78 in commissions from 1996 to 2002 and $57,677 in bonuses from 2001 to 2002, for a total of $938,353.78, plus prejudgment interest.

Riordan does not contest the use of his commission and bonus amounts as a measure of disgorgement, nor does he allege an inability to pay. Instead, Riordan argues that the Division failed to show a causal connection between each securities transaction and the kickback scheme, and therefore requiring him to disgorge his commissions on all of the transactions would be punitive.[122]

Courts have held that "[i]t is proper to assume that all profits gained while [respondents] were in violation of the law constituted ill-gotten gains."[123] The evidence established that Riordan secured a flow of agency securities transactions from the NMSTO as a result of his kickback payments to Montoya. It was not possible to separate out individual transactions awarded to Riordan and conclude that they were not obtained by the kickback scheme simply because they were not linked to specific kickbacks. Given the flow of NMSTO securities transactions directed

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120 *Id.* at 1232.

121 *Zacharias*, 569 F.3d at 472; *see also, e.g., SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1475 (2d Cir. 1996), *cert. denied*, 522 U.S. 812 (1997); *First City Fin.*, 890 F.2d at 1232.

122 Riordan further argues that "[t]he disgorgement amount is the spurious product of the [law judge's] imagined evidence that Mr. Riordan paid kickbacks to Montoya on sales by the [NMSTO], and that each transaction was therefore illegal under the securities laws." Contrary to his argument, and as discussed previously, the evidence supported the finding that Riordan paid secret cash kickbacks to Montoya on sales as well as purchase transactions.

123 *SEC v. Bilzerian*, 814 F. Supp. 116, 121 (D.D.C. 1993) (citing *SEC v. MacDonald*, 699 F.2d 47, 54 (1st Cir. 1983) and *SEC v. First City Fin. Corp.*, 688 F. Supp. 705, 727 (D.D.C. 1988), *aff'd*, 890 F.2d 1215 (D.C. Cir. 1989)), *aff'd*, 29 F.3d 689 (D.C. Cir. 1994).

to Riordan in exchange for his payment of kickbacks, Riordan's commissions and bonuses on all of his NMSTO agency securities transactions, both sales and purchases, during the relevant period should be included in the disgorgement calculation.[124] As noted previously, the record did not contain evidence of Riordan's bonuses prior to 2001.

Ordering disgorgement of Riordan's commissions, including bonuses, will prevent him from reaping substantial financial gain from his violations and deter others from violating the federal securities laws by making illegal conduct unprofitable.[125] We order disgorgement in the amount of $938,353.78, plus prejudgment interest [126] calculated under Section 6621(a)(2) of the Internal Revenue Code,[127] and compounded quarterly.

E. Civil Penalty.

Exchange Act Section 21B authorizes the Commission to impose a civil money penalty where a respondent has willfully violated any provision of the federal securities laws and a penalty is in the public interest. [128] Exchange Act Section 21B establishes a three-tiered system of civil penalties, each with a larger maximum penalty amount applicable to increasingly serious misconduct. The factors we consider in assessing the penalty required in the public interest are whether there was fraudulent misconduct, harm to others, or unjust enrichment, whether the respondent had prior violations, and the need for deterrence, as well as such other matters as justice may require.

We find that civil penalties at the third-tier level are appropriate in response to Riordan's misconduct. The Exchange Act provides that we may impose third-tier penalties where the misconduct "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a

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[124] *See Zwick*, 2007 WL 831812, at *23 (where there was a flow of trades bought by continuing bribery scheme, disgorgement calculation properly included gross commissions on all trades that occurred after scheme's inception).

[125] *See, e.g., SEC v. J.T. Wallenbrock & Assocs.*, 440 F.3d 1109, 1113 (9th Cir. 2006); *United States v. Rx Depot, Inc.*, 438 F.3d 1052, 1058 n.4 (10th Cir. 2006); *First City Fin.*, 890 F.2d at 1230; *SEC v. Tome*, 833 F.2d 1086, 1096 (2d Cir. 1987), *cert. denied*, 486 U.S. 1014 (1988).

[126] Rule of Practice 600(b), 17 CFR § 201.600(b). "[E]xcept in the most unique and compelling circumstances, prejudgment interest should be awarded on disgorgement, among other things, in order to deny a wrongdoer the equivalent of an interest free loan from the wrongdoer's victims." *Coxon*, 56 S.E.C. at 971.

[127] 26 U.S.C. § 6621(a)(2).

[128] 15 U.S.C. § 78u-2.

regulatory requirement," and "resulted in substantial pecuniary gain to the person who committed" the misconduct.[129] Riordan's conduct in paying kickbacks to a state official was fraudulent, deceitful, and in deliberate disregard of the law, and resulted in his substantial pecuniary gain.

The maximum third-tier penalty for misconduct by a natural person committed after February 2, 2001, but before February 14, 2005, was $120,000.[130] In view of the considerable disgorgement and prejudgment interest imposed, we have determined not to impose the maximum civil penalty. Rather, we agree with the law judge that a civil penalty of $500,000 ($100,000 for each of the five October 2002 transactions), which is within the maximum allowed under the statute, is warranted here.

F. Fair Fund.

The law judge ordered that the disgorgement and civil penalties be used to create a fund, pursuant to Rule of Practice 1100, for the benefit of the NMSTO, which was harmed by Riordan's violations.[131] "Sarbanes-Oxley's Fair Fund provision provides the [Commission] with the flexibility by permitting it to distribute civil penalties among defrauded investors by adding the civil penalties to the disgorgement fund." [132] We direct that the civil money penalty and disgorgement amounts ordered in this case be paid into such a fund.

An appropriate order will issue. [133]

By the Commission (Chairman SCHAPIRO and Commissioners CASEY, WALTER, AGUILAR and PAREDES)

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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[129] *Id.*

[130] *See* Debt Collection Improvement Act of 1996, Pub. L. No. 104-134, 110 Stat. 1321-373 (1996) (codified at 28 U.S.C. § 2461 note); 17 C.F.R. § 201.1002.

[131] 17 C.F.R. § 201.1100.

[132] *Official Comm. of the Unsecured Creditors of Worldcom, Inc. v. SEC*, 467 F.3d 73, 82 (2d Cir. 2006) (citing Section 308(a) of the Sarbanes-Oxley Act, 15 U.S.C. § 7246(a)).

[133] 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 ACT OF 1933
Rel. No. 9085 / December 11, 2009

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 61153 / December 11, 2009

Admin. Proc. File No. 3-12829

In the Matter of

GUY P. RIORDAN

ORDER IMPOSING REMEDIAL SANCTIONS

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

ORDERED that Guy P. Riordan be, and he hereby is, barred from association with any broker or dealer; and it is further

ORDERED that Guy P. Riordan cease and desist from committing or causing any violations or future violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Exchange Act Rule 10b-5; and it is further

ORDERED that Guy P. Riordan disgorge $938,353.78, plus prejudgment interest in the amount of $459,516.84, such prejudgment interest calculated beginning from November 1, 2002, in accordance with Commission Rule of Practice 600; and it is further

ORDERED that Guy P. Riordan pay a civil money penalty in the amount of $500,000; and it is further

ORDERED that the disgorgement and civil money penalty be used to create a "Fair Fund" for the benefit of the State of New Mexico's Treasurer's Office pursuant to Commission Rules of Practice 1100 through 1106.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 200, 232, 240, 249 and 274

[Release Nos. 33-9086; 34-61161; IC-29069; File No. S7-10-09]

RIN 3235-AK27

FACILITATING SHAREHOLDER DIRECTOR NOMINATIONS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule; re-opening of comment period.

SUMMARY: In June 2009, the Securities and Exchange Commission proposed changes to the federal proxy rules in "Facilitating Shareholder Director Nominations," Release Nos. 33-9046; 34-60089; IC-28765; File No. S7-10-09 (June 10, 2009), 74 FR 29024 (June 18, 2009) (the "Proposal"). The Commission is re-opening the comment period to permit interested persons to comment on additional data and related analyses that have been included in the public comment file.

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 S7-10-09 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 Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-10-09. 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). These comments also are available for Web site viewing and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, 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: Lillian Brown or Tamara Brightwell, Division of Corporation Finance, at (202) 551-3200, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-4553.

SUPPLEMENTARY INFORMATION: In June 2009, the Commission proposed changes to the federal proxy rules that would require a company, under certain circumstances, to include in the company's proxy statement disclosure concerning a shareholder's, or group of shareholders', nominees for director and to include on the company proxy card the names of those nominees.[1] In addition, the proposed rules would require companies to include in their proxy materials, under certain circumstances, shareholder proposals that would amend, or that request an amendment to, a company's governing documents regarding nomination procedures or disclosures related to shareholder nominations, provided the shareholder proposal does not

1 Facilitating Shareholder Director Nominations, Release Nos. 33-9046; 34-60089; IC-28765; File No. S7-10-09 (June 10, 2009) [74 FR 29024].

conflict with the Commission's disclosure rules, including the proposed new rules. The Commission also proposed changes to certain of our other rules and regulations, including the existing exemptions from the proxy rules and the beneficial ownership reporting requirements. The Proposal was published for comment in the Federal Register on June 18, 2009, and the initial comment period closed on August 17, 2009.

In connection with the Proposal, a variety of data and related analyses have been submitted and included in the public comment file,[2] including data and related analysis by Commission staff. A portion of that data and the related analyses were submitted or added to the public comment file at or after the close of the initial comment period. The Commission is re-opening the comment period to allow interested persons to comment on the additional data and analyses in the public comment file, including the following materials:

- Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation, in Support of Comments by Business Roundtable, NERA Economic Consulting (submitted on August 17, 2009 by the Business Roundtable);
- Why Did Some Banks Perform Better During the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation, Andrea Beltratti and Rene M. Stulz (submitted on September 11, 2009 by the Business Roundtable);
- The Limits of Private Ordering: Restrictions on Shareholders' Ability to Initiate Governance Change and Distortions of the Shareholder Voting Process, The Corporate Library (submitted on November 18, 2009 by the Shareowner Education Network and the Council of Institutional Investors); and

[2] See Comment File No. S7-10-09, available at http://www.sec.gov/comments/s7-10-09/s71009.shtml.

- Supplemental analysis of share ownership and holding period patterns from Form 13F data by the Commission's Division of Risk, Strategy, and Financial Innovation, dated November 24, 2009.

The Commission is re-opening the comment period for the Proposal with regard to the additional data and related analyses for thirty days from the date of publication of this release in the Federal Register.

By the Commission.

Florence E. Harmon
Deputy Secretary

Date: December 14, 2009

ADMINISTRATIVE PROCEEDINGS
FILE NO. 3-13535

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
December 14, 2009

In the Matter of the Application of GATELY & ASSOCIATES, LLC and JAMES P. GATELY, CPA For Review of Disciplinary Action Taken by PCAOB	ORDER GRANTING PARTIAL PROTECTIVE ORDER

On November 2, 2009, Gately & Associates, LLC (the "Firm") and James P. Gately, CPA (together with the Firm, "Applicants"), filed a motion for a protective order in connection with an application for review of disciplinary action taken by the Public Company Accounting Oversight Board ("PCAOB").[1] Applicants argue that information regarding a condition for which Gately was receiving treatment (the "Treatment Information") is "necessary to provide a defense to the PCAOB allegations," but requests that such information be protected from public disclosure and that any reference to such information "be omitted from the record on appeal." Alternatively, Applicants request that Gately and the Firm be referred to by initials. The PCAOB has not submitted a response to Applicants' motion.

Under our Rule of Practice 322, any party "may file a motion requesting a protective order to limit from disclosure to other parties or to the public documents or testimony that contain confidential information."[2] "A motion for a protective order shall be granted only upon a finding that the harm resulting from disclosure would outweigh the benefits of disclosure."[3]

1 Section 105(b)(5) of the Sarbanes-Oxley Act of 2002 generally provides for confidential and privileged treatment of documents and information in connection with a PCAOB inspection or investigation "unless and until" such documents and information are "presented in connection with a public proceeding." 15 U.S.C. § 7215(b)(5). On October 23, 2009, we ordered that these proceedings be public in accordance with our Rule of Practice 301, 17 C.F.R. § 201.301, and described the provisions for filing a motion for protective order under Rule of Practice 322, 17 C.F.R. § 201.322.

2 17 C.F.R. § 201.322(a).

3 17 C.F.R. § 201.322(b).

The Commission recognizes that the Treatment Information could be sensitive. At this stage of the proceeding, we believe that the harm resulting from complete disclosure outweighs the benefits. However, we have determined that disclosure of certain information included in the record might be necessary to the resolution of the issues before us.

Accordingly, IT IS ORDERED that:

1. Except as otherwise provided in this Order, the Treatment Information shall be disclosed only to the parties to this action, their counsel, the Commission, any staff advising the Commission in its deliberative processes with respect to this proceeding, and in the event of an appeal of the Commission's determination, any staff acting for the Commission in connection with that appeal.

2. All persons who receive access to the Treatment Information shall keep it confidential and, except as provided in this Order, shall not divulge the document or information to any person.

3. No person to whom the Treatment Information is disclosed shall make any copies or otherwise use such Treatment Information, except in connection with this proceeding or any appeal thereof.

4. The Office of the Secretary shall place the Treatment Information in sealed envelopes or other sealed container marked with the title of this action, identifying each document, and marked "CONFIDENTIAL."

5. The requirements of sealing and confidentiality shall not apply to any reference to the existence of the Treatment Information or to citation of particular information contained therein in testimony, oral arguments, briefs, opinions, or in any other similar use directly connected with this action or any appeal thereof.

6. The Commission expressly reserves the authority to reach a different conclusion regarding the protective status of any portion of the Treatment Information covered by this Order at any time before it determines the issues raised in the proceeding.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 61162 / December 14, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 3080 / December 14, 2009

Admin. Proc. File No. 3-12208

In the Matter of

KEVIN HALL, CPA
and
ROSEMARY MEYER, CPA

OPINION OF THE COMMISSION

RULE 102(e) PROCEEDING

Grounds for Remedial Action

Improper Professional Conduct

Certified public accountants acting as engagement partner and senior manager were charged with having engaged in improper professional conduct in both the audit and the interim review of a public company's financial statements. *Held*, the matter is *dismissed*.

APPEARANCES:

Miles N. Ruthberg, Peter W. Devereaux, Jamie L. Wine, William R. Baker, III, David A. Becker, and *Kevin H. Metz*, for Kevin M. Hall.

Gary F. Bendinger, Wesley D. Felix, and *Yolanda Hawkins-Bautista*, for Rosemary K. Meyer.

John D. Worland, Jr., Robert W. Pommer III, H. Michael Semler, and *Matthew B. Greiner*, for the Division of Enforcement.

Appeal filed: February 6, 2008
Last brief received: May 21, 2008
Oral argument: July 21, 2009

The Division of Enforcement appeals from the decision of an administrative law judge in a proceeding brought pursuant to Commission Rule of Practice 102(e) ("Rule 102(e)").[1] The law judge found that the conduct of Kevin Hall, CPA and Rosemary Meyer, CPA (together, "Respondents"), in connection with the fiscal year ("FY") 1999 audit of the financial statements of U.S. Foodservice, Inc. ("USF") and the interim review of USF's second quarter FY 2000 financial statements, was not improper under the Rule. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

I.

The Audit of the Fiscal Year 1999 Financial Statements

A. Background

USF is a food service and distribution company. The accounting firm KPMG, LLP ("KPMG") served as USF's independent auditor for fiscal years 1997, 1998, and 1999.[2] Respondents worked on KPMG's audits of USF's financial statements for all three audits.[3]

Hall was the engagement partner, and Meyer was the senior manager, on the audit of USF's FY 1999 financial statements. Hall signed an unqualified audit opinion stating that KPMG had conducted its audit in accordance with generally accepted auditing standards ("GAAS") and that such audit provided a reasonable basis for its opinion that USF's FY 1999 financial statements fairly presented USF's financial position, the results of its operations, and its

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[1] 17 C.F.R. § 201.102(e). With the passage of Section 602 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 794 (2002), this rule was codified in Section 4C of the Securities Exchange Act of 1934, 15 U.S.C. § 78d-3.

[2] During the periods audited by KPMG, USF's fiscal year ended on the Saturday closest to June 30.

[3] Respondents also worked on KPMG's interim review of USF's quarterly financial statements for the second quarter of FY 2000. *See infra* Section III.

cash flows, in conformity with generally accepted accounting principles ("GAAP").[4] It is undisputed that USF's financial statements for FY 1999 do not accord with GAAP.

B. Details of USF's Accounting Fraud

At the time of the FY 1999 audit, USF purchased products from approximately 7,000 vendors and re-sold them to customers such as restaurants, hospitals, and schools. Many of the purchases were made through brokers, many of whom handled multiple vendors.

USF received rebates called promotional allowances ("PAs") from national vendors responsible for the largest volume of USF's purchases. The payment of PAs is a common practice in the food distribution industry that is not itself improper. Most PAs were volume discounts, treated on USF's income statement as a reduction in the cost of sales. On USF's balance sheet, collected PA income increased USF's cash, and uncollected PA income was included in accounts receivable. PA income was extremely important to USF's profitability; it roughly equated to USF's net income.

The Division introduced evidence, and Respondents do not dispute, that during the time at issue, USF was engaged in an earnings management fraud based in part on its accounting for PAs.[5] The scheme involved prepayments of PA income to USF that were improperly booked as income when received although they had not yet been earned, and intentional overpayments by USF to brokers who "sheltered" the excess funds until USF needed them to make up for shortfalls in PA income.[6]

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4 GAAS are generally described in the American Institute of Certified Public Accountants ("AICPA") Codification of Statements of Accounting Standards, hereinafter cited as "AU § __." Section 103 of the Sarbanes-Oxley Act, 15 U.S.C. § 7213, conferred the power to establish auditing standards and rules for public companies on the Public Company Accounting Oversight Board ("PCAOB").

5 The ensuing description of the fraudulent conduct at USF is based largely on the testimony of Timothy Lee, who admits to having participated in the fraud. *See infra*. Although liability for the fraud is not at issue in this proceeding, and we make no findings regarding such liability, we provide information about the fraud as a context for our findings about Respondents' conduct. Our findings with respect to any persons other than Respondents are made solely for the purpose of this proceeding.

6 The accounting fraud continued to grow in scope. USF was acquired by Koninklijke Ahold N.V. ("Royal Ahold") in April 2000, and a new auditor was retained. The fraud only came to light in early 2003, at which time Royal Ahold conducted an internal investigation. Forensic accounting revealed overstatements of pre-tax earnings at USF of

(continued...)

Mark Kaiser, USF's senior vice president, then executive vice president of sales and marketing, and Timothy Lee, executive vice president of USF's purchasing group, orchestrated the accounting fraud. Kaiser initiated the PA prepayment scheme in the mid-1990s. At his direction, USF negotiated deals with some of its largest vendors whereby USF would commit to purchasing a certain amount of product and the vendor would commit to paying USF a stated allowance before the purchases had been completed. Some prepayments were to be made directly by the vendor; others were to be made through a broker who worked with the vendor. Agreements with some vendors allowed the vendor to obtain a refund of the prepayments if USF did not purchase the agreed-upon amounts.

Kaiser instructed Lee to keep the prepayments concealed from everyone outside the purchasing group. For example, Kaiser told Lee to prepare summaries of the vendor purchasing arrangements that omitted the prepayment provisions; if USF's auditors asked to see the contracts, they were given only the summaries.

USF had grown primarily through corporate acquisitions, and its purchasing data resided on computers that did not share a common operating system. For that reason, USF's purchasing group relied on its vendors to calculate and report PAs due to USF. Once a month, the purchasing group calculated how much PA revenue should be recorded and instructed USF's accounting group to book the revenue in USF's general ledger, the main source consulted in the preparation of USF's financial statements. The purchasing group also provided the accounting group with adjustments, representing increases in PA income, at the end of each quarter.

USF's PA account comprised accrued unbilled earnings and outstanding billed receivables. USF recognized all the income from each prepayment upon receipt. Under GAAP, USF should have recorded the prepayments as liabilities, because they were not yet earned. USF would not have met analysts' consensus earnings expectations without these adjustments, but with them USF met or exceeded these expectations every quarter in fiscal years 1998 and 1999.

Kaiser also arranged for income to be sheltered by various entities to satisfy PA balances due. For example, in December 1998 and June 1999, he directed Lee to make lists of outstanding PA billings and to send them to Gordon Redgate, owner of Private Brands. Private Brands was a broker that dealt in canned goods and groceries. Kaiser had arranged to overpay Private Brands for certain goods, and Redgate was holding this excess payment as shelter income for USF.[7] Kaiser, through Lee, instructed Redgate to issue checks returning some of the shelter income that would retire the balances of vendors on the lists, even though Private Brands had no relationship with some of those vendors. Redgate arranged for the checks to be issued as

6 (...continued)
approximately $880 million between April 1, 2000 and December 28, 2002. *See* Royal Ahold's Form 6-K dated May 8, 2003.

7 This overpayment resulted in an overstatement of the cost of goods to USF, and thus a separate GAAP violation.

requested. The checks were treated by USF as PA payments on behalf of the vendors, and, like legitimate PA payments, they were recorded as income.[8]

C. KPMG's Audit of USF's 1999 Financial Statements

Hall's responsibilities as engagement partner for the 1999 audit included planning the engagement, assigning tasks to and supervising the staff, and ultimately drawing the conclusion with respect to the financial statements taken as a whole. Meyer helped Hall plan the audit; she also had responsibilities for supervision, review of workpapers, evaluation of audit evidence, and informing Hall about the progress of the audit and about issues of concern. Seven or eight additional KPMG staff members also worked on the 1999 audit.

Respondents' planning and execution of the FY 1999 audit was informed by their work on previous USF audits. Hall testified that he had found management's representations in connection with those audits correct, giving him confidence in management's integrity. Additionally, USF required its senior management to sign questionnaires asserting their compliance with a code of conduct, a measure Hall regarded as uncommon at that time.[9] Meyer also stated that she had a positive impression of USF management.

Management told Respondents during prior audits that USF did not have formal executed written contracts with its vendors. Respondents asked about the possibility of prepayments of PA income and were told, "There were no prepayments of any amounts that had not been earned, period." A management representation letter signed by five members of USF senior management

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8 The U.S. Department of Justice brought criminal charges against Kaiser and Lee. Based on his wrongdoing at USF, Kaiser was convicted of one count of securities fraud, four counts of false filing with the Commission, and one count of conspiracy. *United States v. Kaiser*, 1:04-cr-00733-TPG (S.D.N.Y. May 18, 2007). He was sentenced to seven years of imprisonment and two years of supervised release, and fined. *Id.* Kaiser has filed an appeal of his conviction, which remains pending. *United States v. Kaiser*, 07-2365-cr (2d Cir. filed June 4, 2007). Lee pleaded guilty to four felony charges of securities fraud, conspiracy, and making materially false and fraudulent statements to the United States government. *United States v. Lee*, 1:04-cr-00712-PKC (S.D.N.Y. July 27, 2004). We brought multiple civil actions and administrative proceedings related to the fraud at USF. *See SEC Charges Thirteen Individuals with Aiding and Abetting Fraud at U.S. Foodservice*, Litigation Rel. No. 19975 (Jan. 22, 2007), 89 SEC Docket 2929 (noting that nine out of thirteen individuals charged with aiding and abetting fraud agreed to settle enforcement actions and listing eight related actions brought by the Commission).

9 Under a rule promulgated by the Commission in 2003 pursuant to Section 406(a) of the Sarbanes-Oxley Act, 15 U.S.C. § 7264(a), companies required by the Exchange Act to file annual reports on Form 10-K must disclose whether they have adopted a code of ethics for certain senior officers, and if not, why not. 17 C.F.R. § 229.406(a).

during an earlier audit stated that USF received no prepayments of PA income. USF's accounting for PA income was consistent with these management representations. Thus, any evidence the auditors uncovered suggesting that there were prepayments should have raised serious issues concerning not only the correct accounting for PAs, but also the integrity of USF's senior management.

KPMG viewed the PA account as posing a high inherent risk, because individual balances were significant within the account, and a high control risk, because KPMG did not intend to rely on USF's internal controls in that area. Accordingly, KPMG concluded that the risk of significant misstatement related to PAs was high for the 1999 audit, and identified as a critical audit objective determining whether "[a]ccounts receivable amounts, both billed and unbilled for vendor rebates (promotional allowances) are accurately presented, properly valued and exist." An audit planning memorandum prepared by Meyer and reviewed by Hall explained that the objective was considered critical "due to the considerable degree of management judgment relating to allowance estimates, unbilled vendor receivable estimates and revenue recognition."

Because USF's controls were unreliable, Hall selected substantive procedures to test the valuation, existence, and completeness of the PAs. Two of these procedures, vouching cash receipts and confirming vendor receivables, are at issue in this appeal.

1. Vouching Cash Receipts

Respondents planned their cash receipts testing procedures to obtain information about cash collection trends and about USF's application of incoming cash to appropriate accounting periods. For their principal cash receipts testing procedure, Respondents selected approximately thirty-five vendors from the billed aged trial balance as of the end of USF's FY 1998 and tracked their account balances during the subsequent fiscal year. From a subset of twenty of those vendors, Respondents sought remittances in amounts greater than $100,000 for detailed cash receipts testwork and obtained a set of fifty checks and one wire transfer, eight of which exceeded one million dollars. Respondents were unable to analyze six of the fifty-one items, identified as the "Discrepancies," satisfactorily on the basis of the information they had. Four of these Discrepancies were among the eight items that exceeded one million dollars.

Three of the Discrepancies raised the possibility of prepayments on PA programs. A $1.8 million wire transfer from Nabisco identified $1.2 million of the payment as an "Advance on USF baked goods agreement," the remittance accompanying a Tyson check for approximately $1.3 million read "99 m/1 prepay," and the remittance accompanying a $240,000 check from Dakota Growers Pasta ("Dakota") read "Final 5year contrt pymnt."[10] Respondents gave USF

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[10] The remaining Discrepancies -- a Dakota check for approximately $124,000, a Seafood Marketing Specialists check for $450,000, and a four million dollar check from Superior

(continued...)

management a PA Discussion Points Memorandum that identified, among other things, these apparent prepayment issues for further discussion with management. Management's renewed reassurances that USF did not receive prepayments or advances of PA income did not resolve Respondents' concerns, and in early August, USF agreed to help Respondents obtain additional third-party documentation.

The record includes almost no documentary evidence showing how Respondents resolved the Discrepancies. One workpaper, captioned "Promotional Allowance Receivables," states that Kaiser "obtained confirmation from the vendors that [the] cash receipts [involved in the Discrepancies] . . . **were not** prepayment on fiscal 1999 programs or other advances" (emphasis in original). The workpaper continues, "See D-32 series for documentation of resolution." The record does not contain a workpaper series denominated D-32 nor does it establish what happened to it or even whether it was ever created.[11] Meyer testified that she intended for the third-party documentation clearing the Discrepancies to be put in the workpapers, although whether in D-32 or elsewhere she could not remember.

The record contains two letters Respondents contend are illustrative of those they relied on in resolving all of the Discrepancies. A letter from Fred Paglia, Regional Vice President of Nabisco Food Service, dated December 28, 1998 (the "Nabisco letter"), reads, in relevant part:

> Congratulations on another year of outstanding performance! We are pleased to inform you that you have maxed out your 1998 Earned Income Program with Nabisco. As discussed, you will shortly be in receipt of a wire transfer of $1,196,203.
>
> Once again, thanks for a record breaking year!

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10 (...continued)
Coffee -- raised questions about USF's applications of the payments to the proper fiscal year or other concerns; the $1.3 million Tyson check raised questions about both prepayment and application.

11 Respondents suggested that the D-32 series, alternatively, was compiled but not properly filed with the completed workpapers, was misplaced while a successor auditor had access to the 1999 workpapers, was misplaced when the original workpapers were copied for production to the Division, or was accidentally never compiled.

A letter signed by Mike Rogers, Vice President, Western Division, Food Service Group, Tyson Food Group, and dated July 21, 1999 (the "Tyson letter"), reads, in relevant part,

> Thank you for your continued commitment and growth pertaining to our program agreements. As a result of this growth, a payout of $2,226,881 was submitted. I look forward to the future and the opportunity to max out our program.[12]

Lee testified that both of these letters used language crafted by Kaiser to be intentionally vague, susceptible of the interpretation that the payments were not prepayments, yet avoiding an explicit statement to that effect.

Meyer testified that the audit team obtained documentation that she claimed resolved the other Discrepancies, but no such documentation is in the record. Hall said that he saw the documentation. Neither Respondent provided detailed information about such purported documents.

In fact, the three checks that raised possible prepayment concerns were prepayments.[13] The checks that raised questions regarding application of funds or other concerns were all received in FY 1999 and applied, at least in part, to FY 1998 invoices; they thus reflected questionable applications of cash received.

Respondents also conducted a more limited test of subsequent cash receipts, *i.e.*, cash received after the end of FY 1999. Auditors commonly perform subsequent cash receipts testing as an alternative procedure in instances where confirmations of accounts receivable are not returned.[14] In such cases, they look to see whether particular balances are subsequently paid down by the entities that owe them.

Here, however, all the confirmation requests sent during the audit were returned, and the record is unclear as to how extensively Respondents intended to review, and did review, the application of the cash received. Meyer testified that Respondents' principal inquiry in the subsequent cash receipts testing was whether PA payments were coming in, with little attention

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[12] The record copy of the Nabisco letter was in KPMG's workpapers, but the Tyson letter was obtained from Lee. Meyer testified that, although she was not certain that she reviewed this letter, she reviewed one consistent with it.

[13] The four million dollar check from Superior Coffee was also a prepayment. *See supra* note 10.

[14] *See* AU § 330.31-32 (suggesting examination of subsequent cash receipts, "including matching such receipts with the actual items being paid," as an alternative procedure to be used in examination of accounts receivable when the auditor has not received replies to positive confirmation requests).

to how those funds were applied. Hall testified that he did not personally review the checks, and that he thought either Meyer or the audit team member who worked with her on cash receipts testing had done so. Meyer testified that, to the extent she looked at checks, she could not remember which ones she saw.

A memorandum in the audit workpapers states, "We vouched the cash receipts to check copies and vendor remittances, as applicable. . . . No problems were noted, cash was appropriately applied." These statements suggest the more detailed matching of payments to invoices that would commonly be done in subsequent cash receipts testing. However, Meyer testified that the phrase "appropriately applied" might merely mean that cash was "received." Hall testified that he was unsure about what Meyer meant by the language and was not "focused on" whether the cash was appropriately applied.

2. Confirming Vendor Receivables

Confirming vendor receivables of PA income involved sending requests to third parties asking them to confirm that certain PA income was owed and earned. Respondents employed this procedure in the FY 1998 audit of USF and expanded it in the FY 1999 audit.

Meyer obtained a list of PA accounts receivable from USF's accounting group; Hall asked USF's chief financial officer to review the list in order to obtain further assurance that the list was accurate and the amounts shown were owed and earned. Meyer selected the thirty highest balances from this list, and collaborated with Hall in choosing a representative sample of five additional balances for confirmation.

GAAS required the team to send the confirmations to persons the auditors believed to be knowledgeable about the information at issue.[15] Respondents testified that, in their experience, it was common practice to obtain contact information for confirmation requests from the audit client. Respondents understood that Kaiser would provide the contact information for the vendors and brokers. They believed that Kaiser was more familiar with and knowledgeable about the PA account than anyone else at USF. Each letter included the representation that "the invoice amount(s) is(are) due to U.S. Foodservice for rebates and/or promotional income earned on products purchased and delivered to U.S. Foodservice prior to July 3, 1999." Meyer "flipped through" the prepared letters with USF's corporate controller. Meyer testified that, in her opinion, this cursory management review of the letters provided additional assurance that the letters were addressed to appropriate people.

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[15] *See* AU §§ 330.16 (recognizing that the intended respondent of a confirmation request has a "direct effect on the reliability of the evidence obtained"), 330.27 (requiring the auditor to send the confirmation "to a respondent from whom the auditor can expect the response will provide meaningful and competent evidence").

Respondents noted that some of the letters were addressed to brokers rather than to vendors, and they noticed that some brokers were being asked to confirm balances for more than one vendor.[16] They considered these facts unexceptionable. Respondents were generally familiar with the role of brokers in USF's purchasing process from work on previous USF audits and conversations with USF management,[17] and they had seen references to many of the brokers on the list in their work on other aspects of the 1999 audit.

There were, however, gaps in Respondents' knowledge regarding the individuals and entities to whom the confirmations were sent. Respondents did not always know which brokers worked with which vendors, so they would not necessarily know whether a confirmation was being sent to an appropriate broker. Moreover, Respondents did not understand that USF did not have PA programs with vendors of commodities.[18] Respondents were therefore unlikely to realize that a confirmation of purported PA income coming from a commodities broker would be anomalous. Additionally, many of the names on the 1999 list were different from those to whom confirmations were sent in 1998. Thus, USF representations regarding addressees for the 1998 confirmations were of limited relevance.

All thirty-five letters were returned directly to the auditors with responses indicating that the information to be confirmed was correct. Respondents considered this persuasive evidence both that the addressees were knowledgeable and that the PA income in question was owed and earned in FY 1999.[19] Respondents did not know, however, that Kaiser had supplied Respondents with contact information for individuals willing to sign confirmation letters that contained false information. Some of the letters were sent to people who had no business relationship with USF. Some of the addresses used were home addresses, or addresses for entities that were not involved in the food distribution business at all.

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[16] Twenty-two of the thirty-five confirmation letters were addressed to seven people. Each of the other letters was sent to a different person.

[17] During the 1998 audit, when some of the confirmation requests were also sent to brokers, Hall had met with USF management "to confirm that, in fact, they understood who the brokers were that we were getting confirmations from." The fact that most of the letters sent in 1998 were returned, with the requested information confirmed, indicated to Respondents that the addressees were knowledgeable.

[18] Vendors typically offered PAs on sales of prepared foods. Commodities such as meat and seafood were sold at a negotiated market price, without PAs.

[19] Respondents included in the confirmations a representation that the amounts in questioned were "earned" in order to provide assurance that those amounts were not prepayments.

D. The Administrative Proceeding

The Order Instituting Proceedings ("OIP") was filed in February 2006. Largely because the administrative proceeding was stayed at the request of the Department of Justice, pending resolution of criminal proceedings arising out of the fraud, the hearing did not begin until July 2007.

The law judge found that Respondents' conduct in planning and executing both the cash receipts testing procedures and the confirmation procedures did not constitute improper professional conduct, and was, in fact, reasonable. The law judge accepted Respondents' testimony that they obtained vendor documentation clearing all six Discrepancies, although she made no explicit finding as to Respondents' credibility.

II.

Analysis of the Fiscal Year 1999 Audit

A. Applicable Professional Standards

Rule 102(e) permits the Commission to censure or deny, permanently or temporarily, the privilege of appearing or practicing before it to persons found to have engaged in improper professional conduct.[20] As relevant here, "improper professional conduct" for accountants includes "[r]epeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission."[21] The term "unreasonable" signifies an ordinary or simple negligence standard.[22] Discipline under Rule 102(e) may be appropriate when the repetition of such negligent conduct shows an accountant's lack of competence to practice before the Commission.[23] The negligence-based

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[20] Rule 102(e), 17 C.F.R. § 201.102(e).

[21] Rule 102(e)(iv)(B)(*2*), 17 C.F.R. § 201.102(e)(iv)(B)(*2*). The OIP also charged that Respondents' conduct was reckless, or highly unreasonable in circumstances warranting heightened scrutiny, either of which (if established) would also constitute improper professional conduct within the meaning of the Rule. For the reasons discussed below, we do not believe the record supports these charges.

[22] *Amendment to Rule 102(e) of the Commission's Rules of Practice*, 63 Fed. Reg. 57,164, 57,169 (Oct. 26, 1998) ("*Amendment to Rule 102(e)*").

[23] *Gregory C. Dearlove*, Securities Exchange Act Rel. No. 57244 (Jan. 31, 2008), 92 SEC Docket 1867, 1909-12 (discussing *Amendment to Rule 102(e)* and finding that Dearlove

(continued...)

standards in Rule 102(e)(iv)(B) are objective, measured by the degree of the departure from professional standards rather than the intent of the accountant.[24] In applying these standards, the Commission does not evaluate actions or judgments in the light of hindsight; it focuses, instead, on what the accountant knew or should have known at the time an action was taken or a decision was made.[25]

GAAS require auditors to exercise due professional care in performing an audit and preparing a report.[26] Auditors must maintain an attitude of professional skepticism, which includes "a questioning mind and a critical assessment of audit evidence."[27] When the audit presents a risk of material misstatement or fraud, auditors must increase their professional care and skepticism.[28] Auditors must obtain sufficient competent evidential matter to afford a reasonable basis for an opinion with respect to the financial statements under review.[29] They may not substitute management representations for competent evidence, and they may not

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23 (...continued)
engaged in improper professional conduct under Rule 102(e)(B)(2)), *petition denied*, 573 F.3d 801 (D.C. Cir. July 24, 2009).

24 *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,167, 57,170. The term "applicable professional standards" "primarily refers to GAAP, GAAS, the AICPA Code of Professional Conduct and Commission regulations"; it encompasses "generally accepted standards routinely used by accountants in the preparation of statements, opinions, or other papers filed with the Commission" and "the body of professional guidance routinely used by accountants." *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,166.

25 *See Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,168 (discussing subparagraph (B)(*1*)). Respondents' conduct is judged against standards in effect at the time of the conduct at issue, although more stringent standards would now apply in some relevant areas. *See supra* note 9 (discussing 17 C.F.R. § 229.406(a)) and *infra* Section II.B.1.b. (discussing PCAOB Auditing Standard No. 3).

26 AU § 230.01.

27 AU § 230.07; *see also* AU §§ 230.08 ("[P]rofessional skepticism should be exercised throughout the audit process."), 330.15 (requiring auditors to exercise an appropriate level of professional skepticism in designing and conducting the confirmation process).

28 AU §§ 312.17, 316.27.

29 AU § 326.22.

become satisfied with less than persuasive evidence merely because they believe that management is honest.[30]

Before analyzing Respondents' conduct in connection with the two substantive procedures at issue, we address Respondents' contention that a finding of improper professional conduct within the meaning of Rule 102(e) may not be based on repeated instances of unreasonable conduct in connection with the audit of a single account -- in this case, they argue, the PA account. Rule 102(e) looks to the number of instances of unreasonable conduct, not the number of accounts. The adopting release for Rule 102(e) recognizes that "[t]he term 'repeated' may encompass as few as two separate instances of unreasonable conduct occurring within one audit."[31] There is no requirement that the two instances pertain to different accounts in that audit. The statement in the release that an auditor's failure to gather evidential material "for more than two accounts" could constitute repeated instances of unreasonable conduct[32] is merely an example of conduct that would fall under Rule 102(e)(iv)(B)(*2*). We therefore see no merit in Respondents' argument.

B. Cash Receipts Testing

1. Resolution of the Discrepancies

a. The Nabisco and Tyson Discrepancies

As discussed above, in the course of cash receipts testing Respondents identified six Discrepancies that they concluded they could not resolve without further information. The record contains two letters, purportedly written by third parties, on which Respondents relied in concluding that the Discrepancies related to the Nabisco remittance and the Tyson wire transfer were not evidence of prepayments of PAs.

Whether these two letters adequately address the concerns that led Respondents to identify the Nabisco remittance and the Tyson wire transfer as Discrepancies is a close question. Respondents knew that USF's accounting for PAs posed a significant audit risk and that any evidence of prepayments would raise critical questions about management integrity. The words "prepay" and "advance" were red flags warning of the possibility that prepayments had been made. Against this background, the resolution of these two Discrepancies assumed particular importance. The Nabisco and Tyson letters, however, do not explicitly address Respondents'

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30 AU §§ 333.02, 230.09. GAAS also requires auditors to plan the audit adequately and to supervise any assistants properly. AU §§ 311.01, 311.11. Violations of these GAAS provisions were not charged.

31 *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,169.

32 *Id.*

concerns: they do not refer to prepayments or advances at all, much less explain why the terms "prepay" and "advance" were used, if the payments at issue were not prepayments.

On the other hand, the letters appear to have been written in the ordinary course of business, predating Respondents' inquiries about the remittance and the wire transfer. Such letters would not necessarily directly address Respondents' concerns. The letters, crafted by Kaiser to be purposefully ambiguous, can be read to imply that the payments are based on past performance. The Nabisco letter congratulates USF on "another year of outstanding performance," apparently summing up the year's sales; this inference is further buttressed by the statement that USF "ha[s] maxed out your 1998 Earned Income Program with Nabisco." The statement that USF would "shortly be in receipt of a wire transfer of $1,196,203," following closely after the apparent references to the completion of an annual purchase cycle, can be read as related to that year's purchases, with the payment based on those purchases. The Tyson letter, while less clearly backward looking, is at least consistent with the theory that the payment at issue was not an advance or prepayment.

Moreover, Respondents' interpretation of the Nabisco and Tyson letters did not occur in a vacuum. Respondents confirmed balances at the end of FY 1998 in their FY 1998 audit, rolled forward the accounts to review activity during FY 1999, then confirmed balances at the end of FY 1999 in their FY 1999 audit. They knew from the workpapers of the predecessor auditors that USF had represented for years that it did not receive prepayments of PAs, and their own audit work in prior years tended to confirm that there were no prepayments. Respondents were not shown contracts with prepayment terms -- only the term sheets that omitted the prepayments. Respondents questioned management about the existence of prepayments, included a representation about the absence of prepayments in the management representation letter, and tailored the language of the confirmation letters to obtain assurances that the amounts to be confirmed were not prepayments.[33]

Given the significance to the audit of properly resolving these two Discrepancies, we do not believe that, on this record, Respondents' conduct exemplifies best audit practices. However, based on the totality of the evidence here, we cannot conclude that Respondents' conduct in resolving the Nabisco and Tyson Discrepancies constituted an instance of unreasonable conduct within the meaning of Rule 102(e).

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[33] The Division argues that Respondents admitted that the Tyson letter was too ambiguous to resolve the Discrepancy. Respondents only admitted, however, that their concerns regarding application of the Tyson payment were not adequately addressed by the Tyson letter in the record. *See supra* note 10 (recognizing that the Tyson remittance posed application as well as prepayment concerns). They assert that they obtained a second letter, which is not in the record, resolving the application concerns. *See infra* Section II.B.1.b. (discussing absence from the record of third-party documentation on which Respondents relied in resolving remaining Discrepancies).

b. Resolving the Remaining Discrepancies

The law judge found both that Respondents obtained and reviewed third-party documentation in resolving the four remaining Discrepancies, and that their reliance on it to resolve those Discrepancies was reasonable. The first finding is a finding of fact, based on the law judge's assessment of Respondents' uncontradicted testimony.[34] The law judge's finding that Respondents' reliance on the third-party documentation in clearing the Discrepancies was reasonable is, on the other hand, a finding of law requiring an application of the reasonableness standard to particular facts.[35] Because neither the purported letters nor adequate descriptions of their contents are in the record, it is impossible to determine whether Respondents' reliance on such documentation to resolve the Discrepancies was reasonable. Conversely, the Division, which has the burden of proof, was unable to demonstrate that Respondents' reliance was unreasonable because the only evidence on this point is Respondents' testimony. Thus, although the law judge lacked sufficient basis to determine that Respondents' conduct was reasonable, we are unable to conclude that Respondents' conduct in resolving the four remaining Discrepancies was unreasonable.

Under current GAAS, audit documentation must "contain sufficient documentation to enable an experienced auditor, having no previous connection with the engagement," to "understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached," with no provision for recourse to external sources.[36] The absence from the workpapers of documents as critically important as the third-party documents that Respondents relied on to clear the Discrepancies (or a detailed summary of those documents) might well constitute a violation of current GAAS. At the time of the FY 1999 audit, however,

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[34] We note, however, that Meyer's testimony that terms used in the workpapers that ordinarily have one meaning might actually mean something different is troubling. In addition to her testimony that a statement in the workpapers that cash was "appropriately applied" might merely mean that cash was "received," she testified that what she described in the workpapers as a review of "executed contracts" might actually have been a review of "executive vendor correspondence," and that a reference to a "purchasing requirement" might really be to an "internal purchasing target."

[35] *E.g.*, *Russell Ponce*, 54 S.E.C. 804, 817 n.33 (2000) (observing that whether activity was manufacturing or research and development for purposes of GAAP "is a mixed question of law and fact"), *aff'd*, 345 F.3d 722 (9th Cir. 2003).

[36] PCAOB Auditing Standard No. 3.

GAAS did not preclude an auditor from supporting his or her report by other means in addition to workpapers, as the law judge found Respondents did here.[37]

2. Other Red Flags in Cash Receipts Testing

The Division also contends that Respondents encountered many other red flags in the course of cash receipts testing, including apparent irregularities in payment patterns and in the application of payments. For example, copies of some payment checks that went into the PA account have remittances showing payors' notes regarding the application of their payments, but USF's application of the funds was often inconsistent with the payors' notes. The Division contends that in failing to analyze these red flags more closely, Respondents failed to show due care and to gather sufficient competent evidential matter to support their audit conclusions.

It is unclear, however, how many of the checks and remittance copies underlying these red flags Respondents personally saw. Meyer testified, without contradiction, that she could remember seeing the three largest checks that gave rise to the Discrepancies, but could not remember which other checks she saw. There is no testimony that Meyer, as opposed to some other member of the audit team, was shown copies of particular checks. Without evidence that Meyer saw specific checks raising application problems, we cannot conclude that it was unreasonable for Respondents to have failed to follow up on those red flags.[38]

KPMG's files contain a chart showing details of questionable applications of payments. We believe that a reasonable auditor would have noticed red flags upon review of this detailed chart. However, the record does not establish who prepared the chart or whether Respondents knew about the chart or the information it contained, and the chart is not contained in the audit workpapers. Because the record does not show that they were aware of the chart, Respondents cannot be found to have failed to exercise due care or maintain an attitude of professional skepticism with respect to the information contained in it.

The audit workpapers contain a different chart that presents some of the same information shown on the chart found in KPMG's files, and it is reasonable to expect that Respondents would have been aware of the chart in the workpapers. However, the questionable applications are less obvious on the workpaper chart, and the information presented on its face is too innocuous to rise to the level of a red flag. The record therefore does not establish that Respondents failed to

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[37] AU §339.01 n.3; *cf. Gregory C. Dearlove*, 92 SEC Docket at 1883 n.39 (finding lack of any evidence in workpapers or elsewhere in the record to be evidence that audit team did not devote substantial, if any, effort to review the areas in question).

[38] If another member of the audit team reviewed the checks and remittances and failed to brief Meyer about them adequately, this might raise questions regarding GAAS standards pertaining to staffing or supervision; no violation of those standards was charged or litigated here.

exercise due care or maintain an attitude of professional skepticism with respect to the information contained in the workpaper chart.

3. Application Issues in Subsequent Cash Receipts Testing

The Division contends that Respondents acted unreasonably in not following up on irregularities encountered in subsequent cash receipts testing, where the application of some payments lacks any evident rationale. The Division bases its argument on the assumption that Respondents' testing of "application" meant the usual auditing practice in conducting subsequent cash receipts testing: examining checks and remittances to see whether a particular vendor's PA payment was applied against that vendor's PA receivable. Such an examination here would have revealed a complex tangle of applications of money where, for example, payments made by several entities were applied against a receivable of yet another, apparently unrelated, entity. Unraveling this tangle could have led to the discovery of accounting irregularities, at least, and perhaps of fraud.

There is no apparent reason why Respondents would have performed subsequent cash receipts testing for the more limited purpose to which they testified, *i.e.*, to verify that money broadly characterized by USF as PA income was being applied against the broad category of PA receivables.[39] However, in light of the law judge's apparent acceptance of Respondents' testimony, and in the absence of contradictory record evidence, we cannot find that it was unreasonable that Respondents failed to notice red flags that would have been apparent had they been conducting a more detailed application testing. For these reasons, we find that the record does not establish that Respondents' conduct with respect to the cash receipts testing procedures in the FY 1999 audit constituted an unreasonable departure from GAAS.

C. Confirming Vendor Receivables

GAAS define the confirmation process as "obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions."[40] Accordingly, GAAS require the auditor to "direct the confirmation request to a third party who the auditor believes is knowledgeable about the

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[39] There was not, under the circumstances of this audit, a GAAS requirement that subsequent cash receipts testing be performed at all. However, GAAS requires that, for any audit procedure undertaken, the auditors must diligently perform the procedure in compliance with all applicable GAAS.

[40] AU § 330.04.

information to be confirmed."[41] AU Section 330.27 emphasizes that particular circumstances may require heightened skepticism:

> If information about the respondent's competence, knowledge, motivation, ability, or willingness to respond, or about the respondent's objectivity and freedom from bias with respect to the audited entity comes to the auditor's attention, the auditor should consider the effects of such information on designing the confirmation request and evaluating the results, including determining whether other procedures are necessary. . . . In these circumstances, the auditor should consider whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect the response will provide meaningful and competent evidence.[42]

Respondents did not act improperly in obtaining confirmation names and addresses from management in the first instance; management is ordinarily in the best position to provide such information. The Division contends, however, that Respondents should have independently investigated each of the addressees, for example by contacting the vendors and addressees, reviewing underlying invoices and other USF accounting records, and/or considering the audit evidence provided by the cash receipts testing.

The Division contends that it was clear at the time of the FY 1999 audit that Respondents were not allowed to use contact information provided by USF management without taking steps to verify that the addresses they were given were truly those of persons knowledgeable about the information to be confirmed. They contend that our decision in *Seidman & Seidman*[43] and the AICPA's Report of the Special Committee on Equity Funding ("Equity Funding Report")[44] required auditors to validate addresses.

Neither *Seidman & Seidman* nor the Equity Funding Report requires Respondents to do more than they did to ascertain that the addresses they used were valid. In *Seidman & Seidman*, the auditors essentially relied on their client's employees to conduct confirmation procedures without supervision or testing by the auditors.[45] Such an abandonment of audit responsibilities is not at issue here. The Equity Funding Report states that ascertaining that valid addresses are used "is already a customary and integral part of confirmation procedures," but it does not explain what validation procedures are required.

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[41] AU § 330.26.

[42] AU § 330.27 (footnote omitted).

[43] 46 S.E.C. 524, 543 (1976).

[44] Report of the Special Committee on Equity Funding 32 (AICPA 1975).

[45] 46 S.E.C. at 543.

We find that Respondents' use of the addresses received from USF management must be viewed in the context of their entire experience in auditing USF. Some of the addressees had returned confirmations in connection with the 1998 audit, indicating their familiarity with the balances to be confirmed. Respondents had received assurances from management that the 1998 addresses were suitable. The USF corporate controller's quick review of the FY 1999 letters indicated to Meyer that he saw nothing questionable about the choice of recipients. Because Respondents had amassed considerable knowledge, both about USF's business generally (including the nature of relationships between USF's vendors and the brokers they worked with) and about specific vendors, we decline to find that Respondents were required to conduct further investigation before using the addresses under the standards expected of a reasonable accountant at the time.

The Division contends that audit evidence provided by the cash receipts testing should have led Respondents to investigate the addressees more closely. However, Respondents were actively pursuing resolution of the Discrepancies, and because their efforts appeared to be leading in the direction of resolution, their work on the Discrepancies did not require them to exercise heightened skepticism with respect to confirmation addressees.

For these reasons, we find that the Division did not establish that Respondents' conduct with respect to the confirmation procedures in the FY 1999 audit constituted an unreasonable departure from GAAS.

III.

The Interim Review of Quarterly Financial Information

The Division contends that Respondents' review of USF financial statements for the second quarter ended January 1, 2000 reflected an additional unreasonable departure from "applicable professional standards." As an initial matter, the initial decision included dicta questioning whether a quarterly review should serve as a basis for Commission discipline. Rule 102(e) covers "generally accepted standards routinely used . . . in the preparation of statements, opinions, or other papers filed with the Commission."[46] Thus, the Rule offers no support for such an assertion. The Rule focuses on violations of "applicable professional standards," not on any particular accounting or auditing procedure. As discussed below, AU § 722 establishes professional standards applicable to interim reviews. Restricting the Rule's application to audits would undermine its effectiveness as a "remedial tool . . . cover[ing] a range of conduct that demonstrates that a professional is a future threat to the Commission's processes."[47]

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[46] *Amendment to Rule 102(e)*, 63 Fed. Reg. at 57,166.

[47] *Id.*

A. Applicable Professional Standards: AU Section 722

The objective and procedural requirements for interim reviews are set forth in AU Section 722. In contrast to an audit, where the objective "is to provide a reasonable basis for expressing an opinion" regarding whether financial statements taken as a whole comply with GAAP,[48] the objective of a review of interim financial information is to provide "a basis for reporting whether material modifications should be made for such information to conform with [GAAP]."[49]

An interim review requires the accountant to apply "his or her knowledge of financial reporting practices to significant matters of which he or she becomes aware through inquiries and analytical procedures," but does not require the accountant to conduct all of the procedures generally performed during an audit.[50] An interim review, unlike an audit, does not generally contemplate "tests of accounting records through inspection, observation, or confirmation" or generally require evidence corroborating management's statements.[51] An interim review accordingly provides "limited assurance" or "negative assurance" that the financial statements comply with GAAP. It may reveal "significant matters affecting the interim financial information, but it does not provide assurance that the accountant will become aware of all significant matters that would be disclosed in an audit."[52]

The inquiries and analytical procedures involved in the review process include comparisons of the interim financial statements with previous statements and the accountant's expectations, as well as assessments of "plausible relationships among both financial and, where relevant, nonfinancial data."[53] If the accountant learns something during the review "that leads him or her to question whether the interim financial information . . . conforms with [GAAP], the accountant should make additional inquiries or employ other procedures he or she considers appropriate to provide the limited assurance for a review engagement."[54] For instance, upon discovery of any "significant changes in accounting practices or in the nature or volume of the client's business activities," the accountant "should inquire about the manner in which the

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48 AU § 722.09.

49 *Id.*

50 *Id.*

51 *Id.*

52 *Id.*

53 AU § 722.13(b).

54 AU § 722.18.

changes and their effects are to be reported."[55] Circumstances requiring additional inquiries include "extraordinary, unusual or infrequently occurring transactions; significant changes in related parties or related-party transactions; . . . or the development of other contingencies."[56]

AU Section 722 instructs the accountant to direct these inquiries to executives responsible for financial and accounting matters.[57] Management's responses to these inquiries, though generally not requiring corroboration, should be assessed for "consistency . . . in light of the results of other inquiries and the application of analytical procedures."[58] "Deferrals, accruals, and estimates at the end of each interim period are frequently affected by judgments made at interim dates concerning anticipated results of operations for the remainder of the annual period."[59]

If the accountant "become[s] aware of matters that cause him or her to believe that interim financial information . . . is probably materially misstated as a result of a departure from [GAAP]," the accountant should discuss those matters with "the appropriate level of management."[60] If management does not appropriately address these concerns, the accountant should contact the audit committee.[61]

B. Background

1. Payments to United Signature Foods During the Second Quarter of FY 2000

The OIP's allegations with respect to the interim review focus on USF payments to United Signature Foods ("Signature"). During the prior fiscal year, USF sold Signature manufacturing assets, conditioned on USF's agreement (the "Supply Agreement") to purchase approximately $750 million of products produced by Signature over a six-year period. The Supply Agreement included yearly purchasing targets, and required USF to pay a shortfall penalty ("Shortfall Penalty") if purchasing for any contract year fell below 95% of the applicable annual target.

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55 AU § 722.16.

56 *Id.*

57 AU § 722.13(f).

58 AU § 722.13(b).

59 AU § 722.08.

60 AU § 722.20.

61 AU § 722.21.

Each month Signature sent USF a notice calculating USF's purchases for the preceding three months and annualizing this three-month amount. If the annualization was less than 85% of the annual target for the corresponding contract year, the Supply Agreement required USF to pay a projected shortfall penalty ("Projected Penalty"). Unlike Shortfall Penalties, Projected Penalties were refundable if, and to the extent that, the total Projected Penalties paid exceeded the Shortfall Penalty amount due at year-end based on USF's actual purchasing during the contract year.

Respondents reviewed the Signature transaction for the FY 1999 audit, and described the transaction in a memorandum (the "Audit Memo") and the notes to the FY 1999 audited financial statements. Those descriptions stated that USF accounted for the asset sale and the Supply Agreement as a single transaction resulting in a net gain of approximately $78 million. USF deferred most of this gain based on Signature's reliance on its purchases and its substantial purchasing obligations under the Agreement. USF planned to recognize the deferred gain over the six-year term of the Supply Agreement. Both the audited financial statement notes and the Audit Memo noted the annual purchase targets and referenced "penalties" for failure to purchase "the minimum product quantities specified" in the Supply Agreement. The Audit Memo further stated, "[t]o the extent that payments are made in any year for failure to meet the minimum purchase targets[,] they will be recorded as incurred." Neither the Audit Memo nor the notes to the financial statements made any mention of the monthly annualizations triggering Projected Penalties.

USF was unable to meet the contractual purchasing targets for the first contract year. However, Signature did not charge a Shortfall Penalty. Instead, it agreed to amend the Supply Agreement. Under this amendment, dated the last day of FY 1999 (the "Amendment"), USF agreed to pay a "Cash Flow Deposit" of $3,251,100. Unlike a Shortfall Penalty, this amount was not forfeited upon payment but was instead treated as an "an advance payment" for future USF payment obligations under the Supply Agreement.

USF's continuing difficulties meeting the purchasing levels contemplated by the Supply Agreement were reflected in the monthly Signature notices during the second quarter of the next fiscal year. These notices charged USF Projected Penalties of approximately $3.2 million in October 1999, $3.3 million in November 1999, $3.0 million in December 1999, and $2.7 million in January 2000. The notices were addressed to USF's general counsel, and copied the USF manager responsible for monitoring its purchasing under the Supply Agreement, and (except for the October notice) the chief financial officer. USF paid these charges and accounted for them as a reduction in the deferred gain from the Signature transaction. Because the payments were recorded as a reduction in deferred gain rather than as an expense, they did not impact USF's reported income in its quarterly financial statements.

2. Discovery of Signature Payments During the Interim Review

Hall and Meyer were not aware of USF's difficulty in meeting the first annual target and, in response to their direct questions, management did not disclose the existence of any amendments to the Supply Agreement. During the interim review, however, Meyer noticed that the deferred income from the transaction had significantly decreased from the FY 1999 amount. Based on discussions with USF's accounting department, Meyer understood that the reduction in deferred gain related to approximately $13-15 million in payments to Signature.

Meyer discussed these payments with the chief financial officer and general counsel, who described them as "cash flow deposits" for future purchases. At the hearing, she also testified that USF's accounting records identified the payments as "cash deposits." She testified that "at no time did [she] believe or understand [the purchasing] to be below minimum purchasing requirements in the contract," and that she had not generally been concerned about USF's ability to meet the annual targets because she understood that the targets were based on historical purchasing levels and that USF sales were growing. Meyer testified:

> The payments, as I understood them, were not penalty payments . . . . US Foodservice was [Signature's] main customer, and it certainly made sense that if they were not meeting every purchase dollar that they wanted to, that [Signature] needed cash flow to continue to operate and manufacture the product that they needed.

Meyer's workpaper notes state, "13M in pymts to United – Not meeting purchasing requirements." During the hearing, Meyer maintained that this notation referenced USF's "internal targets" or "internal projections" and not contractual targets. Her cross-examination by the Division included the following exchange:

Q: So you understood at the time that if the company fell below the 85 percent threshold target during any 13-week period, that significant penalties would have to be paid?
A: Could be, yes, sir.
. . . .
Q: And, in fact, KPMG had advised or had concluded that, in the event that the company made such shortfall penalties, that those penalties would be . . . . recorded as incurred?
A: Yes.
Q: You would agree the language in your [Audit Memo], it says recorded as incurred, in fact means that the penalties would be expensed?
A: The penalties, if they were penalties, that was my understanding.

Meyer also discussed these payments with Hall, who testified that the description of payments as "cash deposits to help United Signature with cash flow" "seemed reasonable." Hall also testified that he had "a vague recollection of discussing the matter with [the chief financial officer], and he indicated, as I recall, that they were going to make the purchase commitment as of the end of the fiscal year and that they would not incur any penalties under the contract." Like Meyer, Hall testified that he had been familiar with the Projected Penalties calculation based on the prior fiscal year review of the Supply Agreement, but that "[t]here was never any concern" about USF's ability to meet the contractual purchasing targets," and that he did not know that purchasing had fallen below the 85% mark during that quarter. He testified that he did not recall whether he had any conversations regarding the extent of the decline in purchasing, but referred to "the representations we historically got from the company" regarding its compliance with its contractual obligations. Respondents were not aware of the monthly notices demanding Projected Penalties and did not speak with the purchasing manager during the review.

Hall also distinguished Shortfall Penalties and Projected Penalties. He testified that "[P]rojected [P]enalties that are paid during the interim [periods] . . . are not penalties" because they "were recoverable to the extent that [USF] achieved the target by the end of the fiscal year."

C. Analysis

Generally, an issuer's losses must be expensed, or charged to income, when incurred. Statement of Accounting Standards No. 5 ("FAS 5") outlines USF's accounting and reporting obligations for the contingencies at issue in this case.[62] A loss contingency is "an existing condition, situation, or set of circumstances involving uncertainty as to possible . . . loss . . . that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm . . . the incurrence of a liability."[63] FAS 5 requires a loss contingency to be expensed if both (a) "Information available prior to issuance of the financial statements indicates that it is probable that . . . a liability had been incurred at the date of the financial statements;" and (b) "the amount of the loss can be reasonably estimated."[64] FAS 5 further provides that disclosure, rather than a charge to income, is required if the contingent loss is reasonably possible,[65] and that gain contingencies should usually not be recorded until the gain is realized.[66] As applied here, the inquiry would focus on whether USF would fail to meet the annual purchasing target, resulting in forfeiture of a previously paid Projected Penalty and/or the assessment of a Shortfall Penalty.

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[62] On June 30, 2009, the Financial Accounting Standards Board ("FASB") issued the FASB Accounting Standards Codification™ ("FASB ASC"), and established the FASB ASC as the source of authoritative U.S. GAAP. FASB ASC is effective for interim and annual periods ending after September 15, 2009. *See Commission Guidance Regarding the Financial Accounting Standards Board's Accounting Standards Codification*, Exchange Act Rel. No. 60519A (Aug. 19, 2009), 96 SEC Docket 19829. The provisions of FAS 5 are currently codified primarily in FASB ASC Topic 450, Contingencies. Because the conduct at issue took place prior to the codification, we continue to use the designation FAS 5 in this opinion.

[63] FAS 5 ¶ 1.

[64] *Id.* ¶ 8.

[65] *Id.* ¶ 10.

[66] *Id.* ¶ 17.

The Division contends that Respondents failed to reasonably assess whether the payments to Signature during the quarter, which the Division characterizes as "apparent penalties," should have been expensed under FAS 5 as evidence of a probable (*i.e.*, likely) and estimable failure to meet Supply Agreement purchasing targets. The law judge deemed Respondents' review reasonable, finding that USF "maintained that it was behind on its own internal purchasing targets" and "never represented . . . that the payments were penalty payments."

On appeal, the Division contends that Respondents failed to apply appropriate professional skepticism to the cash flow payment explanation from management. Faulting Respondents for failing to question the purchasing manager or to employ additional inquiries or procedures, the Division argues that Respondents violated their obligation to follow up on information raising questions about the compliance of the financial statements with GAAP. The Division contends that Respondents had an obligation to further test managements' explanations, arguing that "[t]here is no rational reason why Signature would accept 'cash flow deposits' when the contract by design provided for penalties to address the exact situation."

However, a review "does not involve obtaining corroborating evidential matter for responses to inquiries" or "search and verification." On the one hand, the symbiotic relationship between the two companies and USF's Form 10-K disclosure regarding warehouse consolidation supported the plausibility of the cash flow/internal targets explanation. In addition, although Respondents were not aware of the Amendment during the review, the Amendment contradicts the Division's contention that Signature's willingness to be flexible regarding USF's purchasing obligations was implausible as a business matter.

On the other hand, we agree with the Division that Respondents' assessment of management's explanations for plausibility should also have taken into account the monthly Projected Penalty calculations required under the Agreement. Both Respondents testified that they were familiar with the Projected Penalty provisions but that they were not aware that USF's purchasing had fallen below the 85% target calculation. Given this knowledge, a reasonable inquiry regarding payments to Signature based on a downturn in purchasing should have directly asked whether such payments, regardless of the nomenclature applied to them, had been triggered by the Projected Penalty obligations in the Agreement. However, Respondents' testimony did not directly address whether their review inquiries focused on this key issue.

Moreover, regardless of whether management characterized the payments as "penalties," "cash flow payments," or "advances," because Respondents knew that USF's rights with respect to these payments depended on future events, the accounting for such payments should have triggered a consideration of FAS 5. Such analysis could have appropriately considered both the "probable and estimable" test for recognition of a loss contingency and the guidance disfavoring recognition of gain contingencies. The contractual Projected Penalty calculations should have informed this FAS 5 analysis, and Respondents should have considered the plausibility of management's explanations in light of their understanding of those calculations.

On the record before us, however, we cannot determine whether Respondents considered the appropriate contractual provisions as part of a FAS 5 assessment. The testimony on this point is ambiguous, in part due to the inconsistent use of key contractual terms during the hearing. For instance, the Signature payments at issue were repeatedly described as Shortfall Penalty payments (assessed annually under the Agreement) despite clear record evidence that the payments made during the quarter were Projected Penalty payments (assessed monthly). Also, although Meyer testified that "[a]t the time [she] was doing this work, there was no discussion of penalty payments," it is unclear from the context, and Meyer was not asked to clarify, whether this statement referred to either or both Projected Penalty and Shortfall Penalty payments.

The contractual differences between Shortfall and Projected Penalty payments were significant for FAS 5 purposes. Because Shortfall Penalties were based on a final year-end calculation, GAAP required any such payments to be expensed as a loss when probable and reasonably estimable.[67]

Projected Penalty payments, however, were based on projections and were subject to refund pending the Shortfall Penalty calculation of purchasing volume for the entire year. The correct accounting treatment for a known Projected Penalty payment presents a close judgment call as to which reasonable accountants could disagree. Here, Respondents' expert suggests that the payment of a Projected Penalty should have triggered a facts-and-circumstances based analysis of the likelihood of achieving the year-end purchasing target. The Division's expert suggests that the actual payment of a Projected Penalty is evidence of a likely failure to meet the annual target triggering an obligation to expense, and that the failure to expense the payments amounted to a premature recognition of a gain contingency.

Both approaches are grounded in relevant accounting guidance. The facts-and-circumstances based analysis espoused by Respondents' expert is supported by interim review guidance indicating that interim financial statements may appropriately reflect management judgements at that time "concerning anticipated results of operations for the remainder of the annual period,"[68] and FAS 5 guidance indicating that the recognition of a contingent loss must be based on a "probab[ility] that one or more future events will occur confirming the fact of the loss." This guidance supports an accounting approach based on management representations regarding the probability of future refund or application of payments prior to contract-year end. FAS 5 guidance disfavoring premature recognition of contingent gains, however, could be read to support an approach requiring automatic recognition of any Projected Penalty as a contingent loss, as described by the Division's expert.

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[67] Meyer testified that "the penalties, if there were penalties" should have been expensed, but that "in [her] understanding, these [payments] were not penalty payments."

[68] AU § 722.08.

In any event, the relevant question under Rule 102(e) is not whether the accounting for the payments reflected in the financial statements was correct, but whether Respondents' review of the accounting was reasonable in light of the relevant FAS 5 guidance and their knowledge of the Supply Agreement.[69] The interim review workpapers offer minimal and ultimately ambiguous evidence in this regard. The only other record evidence is Respondents' testimony and several statements in the report of Respondents' expert.

Hall's testimony was generally consistent with the Respondents' expert's emphasis on the FAS 5 "probable and estimable" standards for recognition of a contingent loss. Hall emphasized the distinction between Shortfall Penalties and Projected Penalties, stressing that Projected Penalties would be refunded "to the extent that [USF] achieved the target by the end of the fiscal year" and focusing on USF's assurances that annual contractual targets would be met. Similarly, Respondents' expert report describes Meyer's assessment in terms of the contingent loss factors, indicating that "Ms. Meyer was . . . told by USF management that USF intended to and could meet the contractual purchasing requirements by the end of the contract year and thus the possibility that USF would incur penalties under the contract was remote."

Although the Division contends that Hall and Meyer should have further tested or questioned management's explanations, the Division did not press Respondents at the hearing about the degree to which they did so. For example, the Division's expert report stated that Respondents should have asked management, "Why would Signature accept a prepayment from USF when instead it had the contractual ability to charge USF penalties?" At the hearing, however, the Division did not ask Respondents whether they asked or considered this question.

Some of Respondents' testimony could be read as supporting the Division's contention that Respondents failed to appropriately evaluate management's explanations for the payments against the Projected Penalty payment calculations required under the Supply Agreement. For instance, Hall testified that he did not recall asking how far below the threshold USF's purchasing had fallen during the quarter, and Meyer testified that "[a]t the time [she] was doing this work, there was no discussion of penalty payments." Ultimately, however, this testimony is not conclusive in light of the inconsistent use of key contractual terms during the examination of Respondents at the hearing as described above, and because Respondents were not directly asked to explain whether their FAS 5 assessment took the Projected Penalty calculations into account.[70]

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[69] *See, e.g.*, *Dearlove*, 92 SEC Docket at 1889-90 & n.51 (accountant's conduct may violate GAAS even if the underlying financial reporting complies with GAAP).

[70] The Division's suggestion that Respondents should have questioned the purchasing manager diverges from interim review guidance directing inquiries to officers with responsibility for "financial and accounting matters" rather than employees with operational responsibility, and stating that responses to inquiries during a review do not need to be supported by corroborating evidential matter.

(continued...)

Given the limited assurance standard for interim reviews and gaps in the development of potentially dispositive record evidence, we believe that the record does not establish, by a preponderance of the evidence, that Respondents' conduct during the interim review was an unreasonable departure from applicable professional standards.

V.

Respondents' Due Process Claims

A. Background[71]

In opening its investigation of USF accounting practices in early 2003, the Division issued a document subpoena covering professional services provided to USF by Respondents. In April 2005, the Division issued Wells notices to notify Respondents that it was considering recommending that the Commission institute administrative proceedings against them, and offering Respondents an opportunity to submit a statement to be forwarded to the Commission in conjunction with the Division's enforcement recommendation.[72] Respondents submitted a joint Wells submission through their then-counsel ("Former Counsel") in May 2005.

Separately, in July 2005, we authorized a preliminary investigation into whether certain counsel, including Former Counsel, had engaged in conduct subject to discipline under Rule

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70 (...continued)
Respondents note that both the chief financial officer and the general counsel knew that the payments were Projected Penalty payments, but instead characterized the payments as cash flow payments in response to Respondents' direct inquiries. The Division expert's suggestion that Respondents' assessment of management's responses should have taken into account the management "integrity issues" from the previous year's audit assumes that Respondents were, at that time, aware of reason to question management's integrity. The record does not include evidence that Respondents harbored such suspicions during the review.

71 Respondents have moved to limit public disclosure of their arguments regarding the Division's investigation. On July 20, 2009, we issued an order granting Respondents' motion. Exchange Act Rel. No. 60346 (July 20, 2009), 96 SEC Docket 18986. As noted in that order, the requirements of sealing and confidentiality do not apply to "any reference to the existence of the [c]overed [a]rguments or to citation of particular information contained therein" in, among other things, the opinion "or in any other similar use directly connected with this action or any appeal thereof." Although we are dismissing this action, because of their potential significance in future cases, we address Respondents' due process claims separately in this Section V.

72 *See* 17 C.F.R. § 202.5(c). This is known as the Wells process.

102(e) (the "Counsel Investigation"). Consistent with Commission rules, we directed members of the Office of General Counsel ("OGC") to conduct the Counsel Investigation.[73]

The Counsel Investigation was non-public,[74] and Commission staff did not inform Respondents of the Counsel Investigation when it was initiated. Former Counsel continued to represent Respondents, including in correspondence and meetings with the Division, between May and August 2005. In October 2005, Former Counsel, joined by new counsel for Hall,[75] submitted a second, superseding joint Wells submission ("Superseding Wells Submission"). Respondents state, and the Division does not dispute, that Respondents were not subpoenaed to provide sworn testimony during the investigation. In January 2006, OGC advised Former Counsel of the Counsel Investigation. The Counsel Investigation was subsequently closed without any action being brought.

In February 2006, we issued the OIP for this case. The OIP included allegations, among other things, that Respondents reviewed USF contracts containing prepayment provisions (the "Prepayment Review Allegations"). In March 2006, new counsel entered a notice of appearance on behalf of Meyer (together with Hall's new counsel, "Current Counsel").

The hearing before the law judge was originally scheduled to begin in March 2006, but was stayed until April 18, 2007 upon a motion by the United States attorney for the Southern District of New York. On April 20, 2007, the Division indicated that it had decided not to pursue the Prepayment Review Allegations at the hearing. On June 20, 2007, Respondents filed an interlocutory motion with the Commission seeking dismissal of the proceedings. Respondents contended, among other things, that the Counsel Investigation deprived them of effective assistance of counsel and that the Commission's decision to institute proceedings was "tainted" by the Division's investigation. We denied Respondents' motion, indicating that "once we have exercised our prosecutorial discretion to institute a proceeding, the appropriate remedy for any challenge to that exercise of discretion is to litigate the proceeding to a final decision." Respondents renewed their due process claims during the hearing, but the law judge rejected these claims, ruling that the hearing satisfied their due process right to defend themselves against the charges.[76]

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73 OGC, rather than the Division, is charged with investigating and prosecuting potential violations of Rule 102(e) by attorneys. 17 C.F.R. § 200.21(a).

74 17 C.F.R. § 202.5(a) ("Unless otherwise ordered by the Commission, the investigation . . . is non-public and the reports thereon are for staff and Commission use only.").

75 The circumstances prompting Hall's substitution of new counsel are not evident from the record.

76 The administrative law judge issued a separate decision under seal addressing

(continued...)

B. Respondents' Contentions

On appeal, Respondents argue that their due process claims constitute independent grounds for dismissal of the Rule 102(e) charges. Respondents argue that the Division had a duty to inform them of the Counsel Investigation when it was initiated, and that the Division "deprived [them]. . . of the opportunity to knowingly exercise [their] choice of counsel" when it did not make this disclosure. Asserting that the Counsel Investigation created a conflict of interest violating their right to effective representation, Respondents claim that this right was violated "the moment that Former Counsel was ineffective" due to the initiation of the separate Counsel Investigation. Respondents further contend that the Division engaged in an "incomplete and biased" investigation that rendered our issuance of the OIP arbitrary and capricious. In support of this claim, they focus on the Division's decision not to pursue the Prepayment Review Allegations and the law judge's subsequent decision finding that they had not engaged in improper professional conduct. Respondents argue that our issuance of the OIP caused them reputational harm. Finally, Respondents argue that the investigation violated Commission ethical guidelines. We address these contentions in turn.

C. Analysis

1. Choice of Counsel.

The right to counsel before administrative agencies is grounded in section 555(b) of the Administrative Procedure Act ("APA"), which entitles a "person compelled to appear in person before an agency or representative thereof . . . to be accompanied, represented, and advised by counsel."[77] Commission rules, echoing the APA right, cover "[a]ny person compelled to appear, or who appears by request or permission of the Commission, in person at a formal investigative proceeding,"[78] and a "witness who is sworn in a proceeding pursuant to a Commission order for investigation or examination."[79] This provision of the APA had not attached during Former Counsel's involvement in the Division's investigation because Respondents were not compelled

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[76] (...continued)
Respondents' procedural contentions. The factual findings in this Section V of the opinion rely primarily on stipulations of fact submitted under seal to the administrative law judge by the Division and Respondents.

[77] 5 U.S.C. § 555(b). The APA also entitles parties to agency proceedings to appear with counsel. *Id.*

[78] 17 C.F.R. § 203.7(b); *see also* 17 C.F.R. § 201.102(b) ("In any proceeding, a person may be represented by an attorney at law. . . .").

[79] 17 C.F.R. § 203.4(a).

to appear or to provide sworn testimony during the investigation.[80] Although Former Counsel filed written submissions on behalf of Respondents as part of the Wells process, this process is conducted at the Division's discretion[81] and does not confer procedural rights.[82]

A Commission investigation does not confer any party with a general right to information about the Division's view of their counsel, or any potential parallel investigations. In suggesting the contrary, Respondents rely on cases applying the right to counsel under the APA "to imply the concomitant right to the lawyer of one's choice," and preventing the Commission from sequestering a witness from counsel during sworn testimony.[83] In those cases, however, the respondents asserted that the Commission directly interfered with their consultation with counsel during testimony. Respondents here do not allege interference in their ability to consult with the counsel of their own choosing either before or after these proceedings were instituted.

2. Effective Assistance of Counsel.

Although Respondents attempt to characterize their claim as a deprivation of their right to effective assistance of counsel, the Commission does not have a general obligation to ensure the competence or suitability of Respondents' representation during an investigation.[84] Fifth

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80 A requirement investing all parties potentially implicated in an investigation with such procedural rights would be "virtually impossible" to administer and "'would unwarrantedly cast doubt upon and stultify the [Commission's] every investigatory move.'" *SEC v. O'Brien*, 467 U.S. 735, 749 & 751 (1985) (quoting *Donaldson v. United States*, 400 U.S. 517, 531 (1971)).

81 *See* 17 C.F.R. § 202.5(c) (describing the Wells process by stating: "Persons who become involved in preliminary or formal investigations may, on their own initiative, submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation. Upon request, the staff, in its discretion, may advise [persons under investigation] of the general nature of the investigation . . . .").

82 *Wellman v. SEC*, 79 F.R.D. 341, 353 (S.D.N.Y. 1978).

83 *See SEC v. Higashi*, 359 F.2d 550, 553 (9th Cir. 1966) (applying the APA provision to subpoenaed testimony); *SEC v. Csapo*, 533 F.2d 7, 10 (D.C. Cir. 1976) (interpreting the statutory right to cover "any person summoned to appear before a federal agency").

84 In fact, administrative proceedings generally do not trigger a specific right to the effective assistance of counsel. *Hammon Capital Mgmt. Corp.*, 48 S.E.C. 264, 266 (1985); *see also Williams v. Wynne*, 533 F.3d 360, 369 (5th Cir. 2008) (finding Sixth Amendment inapplicable to an administrative hearing); *Father & Sons Lumber & Bldg. Supplies v. NLRB*, 931 F.2d 1093, 1096-97 (6th Cir. 1991) (finding that neither the Fifth Amendment nor the APA conferred a separate right to effective assistance of counsel in an administrative hearing).

Amendment due process principles protecting the "right to a fair and impartial hearing"[85] apply to adjudicative, not investigative, processes.[86] These protections are satisfied by the "opportunity to appear as a claimant and to have a full hearing" in connection with the charged violations.[87] Accordingly, the preliminary determination to institute a proceeding does not trigger due process protections "so long as the requisite hearing is held before the final administrative order becomes effective."[88] Government actions taken before the institution of proceedings trigger a due process remedy only if such conduct both actually prejudiced the defense at the hearing and constituted "an intentional device to gain tactical advantage" at the hearing.[89]

Respondents have not alleged or demonstrated either of these required elements for due process relief.[90] Effective assistance inquiries based on counsel conflicts of interest, like other

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85 *Friedman v. Rogers*, 440 U.S. 1, 18 (1979).

86 *O'Brien*, 467 U.S. at 742 (holding that targets of SEC investigations are not entitled to notice of third party subpoenas and stating that "an administrative investigation adjudicates no legal rights" (citing *Hannah v. Larche*, 363 U.S. 420, 440-43 (1960)).

87 *Ewing v. Mytinger & Casselberry, Inc.*, 339 U.S. 594, 598 (1950); *see also Withrow v. Larkin*, 421 U.S. 35, 46 (1975) (stating that administrative agencies have an obligation to provide a "fair trial in a fair tribunal" as "a basic requirement of due process").

88 *Ewing*, 339 U.S. at 598.

89 *United States v. Marion*, 404 U.S. 307, 324 (1971) (finding that a delay in indictment did not constitute a due process violation); *see also United States v. Stringer*, 521 F.3d 1189, 1200 (9th Cir. 2008), *amended in part*, 535 F.3d 929, 933 & 941 (9th Cir. 2008) (suggesting that government "deceit or an affirmative misrepresentation" interfering with a client's relationship with counsel will give rise to potential due process claim if such conduct resulted in "actual and substantial prejudice" to the client's defense during the trial).

90 Although Respondents cite cases discussing the rights of criminal defendants under the Sixth Amendment, these cases are inapplicable to administrative proceedings because "Sixth Amendment [protections] are explicitly confined to 'criminal prosecutions,'" *Austin v. United States,* 509 U.S. 602, 608 (1993), and only attach after the formal institution of such criminal proceedings. *Massiah v. United States*, 377 U.S. 201, 205 (1964) (indicating that the right attaches from the time of the arraignment).

Moreover, Respondents improperly conflate authority addressing two distinct rights under the Sixth Amendment -- the right to choice of counsel and the right to effective representation. The authority cited by Respondents, however, expressly distinguished between "the right of counsel of choice -- which is the right to a particular lawyer regardless of comparative effectiveness" and "the right to effective counsel -- which imposes a baseline

(continued...)

due process claims, focus on the adjudication of the charged person's legal rights.[91] For instance, we have disqualified an attorney from participating in a hearing when the attorney's divided loyalties posed a potential threat to "the apparent fairness and integrity of the proceedings."[92] Respondents here do not cite any evidence, however, that their right to a fair and impartial adjudication of the charges against them -- the touchstone of due process -- was compromised by their representation by Former Counsel during the investigation.

In addition, Respondents have not shown that any of the Division's decisions during its investigation constituted bad faith efforts to frustrate Respondents' ability to defend themselves against the charges, or to undermine the integrity of the hearing. In fact, we expressly found in *Trautman Wasserman & Co.*[93] that the non-disclosure of a parallel investigation of respondent's counsel during the Wells process does not constitute grounds for dismissal of charged violations. We held that "the Division's decision during the Wells process to withhold information about certain facts . . . does not give rise to any right or remedy,"[94] and that in any case the substitution of new counsel before the hearing "cur[ed] any alleged harm [respondent] may have suffered because of [his former counsel's] alleged conflict."[95] Here, as in *Trautman Wasserman*, the retention of Current Counsel prior to the hearing averted any potential prejudice to the Respondents' defense, and thereby averted any potential due process harm.

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90 (...continued)
requirement of competence on whatever lawyer is chosen or appointed." *United States v. Gonzales-Lopez*, 548 U.S. 140, 148 (2006). The Court specifically reaffirmed the prejudice requirement for a finding of ineffective assistance. *Id.* at 147. As noted in the text, Respondents were not deprived of their right to the lawyer of their own choosing, and have not shown any prejudice to their ability to defend themselves at the hearing.

91 *Strickland v. Washington*, 466 U.S. 668, 686 (1984) ("The benchmark for judging any claim of ineffectiveness must be whether counsel's conduct so undermined the proper functioning of the adversarial process that the trial cannot be relied on as having produced a just result."); *see also* 2 Am. Jur. 2d *Admin. Law* § 120 (2008) ("As long as no legal rights are adversely determined during the investigation, the demands of due process are satisfied if procedural rights are granted in the subsequent proceedings.").

92 *Clark T. Blizzard*, 55 S.E.C. 650, 655 (2002) (disqualifying counsel proposing to engage in simultaneous representation of parties at a hearing when this representation generated "serious potential for prejudice to the integrity of the proceeding").

93 Exchange Act Rel. No. 55989 (June 29, 2007), 90 SEC Docket 3098.

94 *Id.* at 3106.

95 *Id.* at 3105-3106.

3. Claimed "Arbitrary and Capricious" Institution of Proceedings.

Respondents attempt to distinguish *Trautman Wasserman* by claiming that the Division conducted an "incomplete and biased investigation," and that Division bias in turn tainted the Commission's decision to institute proceedings. However, Respondents do not offer any support beyond mere speculation for their claim that the Division was motivated by improper bias in assessing their explanations for their conduct, or in declining to take their investigative testimony. Participants in the investigative process are not entitled to an uncritical or even a neutral Division assessment of their asserted defenses,[96] or to a right to provide investigative testimony.[97] These aspects of the Division's investigation fall squarely within the scope of the prosecutorial discretion that it routinely exercises in conducting multi-party investigations, and it is well established that such investigations do not trigger "the full panoply"[98] of safeguards that are required during an adjudication.[99] This distinction is maintained in order to "prevent the sterilization of investigations by burdening them with trial-like procedures."[100]

In fact, the Supreme Court has recognized the propriety of affording Commission staff "considerable discretion in determining when and how to investigate" potential securities law violations,[101] and the pragmatic considerations weighing against requiring the Division to "inform[] anyone, including targets, of the existence and progress of its investigations."[102] As the Court recognized, such a "remedy would . . . have the effect of laying bare the state of the Commission's knowledge and intentions midway through investigations," and "could significantly hamper the Commission's efforts to police violations of the securities laws."[103]

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96 *See Marshall v. Jerrico*, 446 U.S. 238, 248 (1980) (stating that the neutrality requirements "designed for officials performing judicial or quasi-judicial functions . . . are not applicable to those acting in a prosecutorial or plaintiff-like capacity").

97 *Hannah*, 363 U.S. at 445-46 ("[W]hen these agencies are conducting nonadjudicative, fact-finding investigations, rights such as apprisal, confrontation, and cross-examination generally do not obtain.").

98 *Hannah*, 363 U.S. at 442.

99 *See O'Brien*, 467 U.S. at 742-43 (holding that targets of SEC investigations are not entitled to notice of third party subpoenas).

100 *Hannah*, 363 U.S. at 447-48.

101 *O'Brien*, 467 U.S. at 744-45.

102 *Id.* at 744-45, 749-751.

103 *Id.* at 750 n.23.

Moreover, Respondents' suggestion that the Commission's decision to institute these proceedings could in some way have been tainted by any alleged improper conduct by the Division's investigation ignores the independence of the Commission's decision-making process.[104] We authorized and instituted these proceedings based on our "own consultations, deliberations and conclusions with respect to [the Division's] recommendations."[105] In the course of doing so, we reviewed the Respondents' Wells submission, and Respondents have not pointed to any defense they were prevented from including in this submission in connection with the Counsel Investigation.

The decision to institute proceedings was not meant to resolve disagreements between the Division and Respondents regarding the evidence; such disagreements are best left to be resolved at the hearing authorized by the OIP.[106] The Supreme Court, recognizing the "different bases and purposes" for a charging decision and a subsequent adjudication, has expressly stated that "there is no incompatability between [an] agency filing a complaint based on probable cause and a subsequent decision . . . that there has been no violation."[107] Such a resolution does not demonstrate impropriety in the charging decision or investigation, but rather the nature of the adjudication process itself.

Although the Division chose not to pursue the Prepayment Review Allegations at the hearing, Respondents do not substantiate their claims that the original inclusion of those

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104 We have previously rejected claims that "disqualifying bias on the part of the Commission may be inferred from alleged bias of its members or staff." *Jean-Paul Bolduc*, 54 S.E.C. 1195, 1199 (2001).

105 *Edward H. Kohn*, Freedom of Information Act Rel. No. 19, 1975 SEC LEXIS 1217 (July 15, 1975); *see also Stuart-James Co.*, 50 S.E.C. 468, 469 (1991) (stating that the Commission, "not the staff, [is] ultimately responsible for exercising control over the agency's administrative proceeding docket").

106 *Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations*, Exchange Act Rel. No. 9796 (Sept. 27, 1972) (noting that disputes about facts underlying the institution of proceedings "likely . . . can be resolved in an orderly manner only through litigation").

107 *Withrow*, 421 U.S. at 57-58. Given this authority distinguishing between the requirements for filing a complaint and the subsequent decision, we reject Hall's suggestion that the Commission must justify the inclusion of these charges in the OIP based on the standard of judicial review for "final agency action" under the APA. Issuance of an OIP is not final agency action. *See FTC v. Standard Oil Co.*, 449 U.S. 232, 493 (1980) (holding that issuance of complaint is not "final agency action").

allegations in the OIP was improper.[108] Moreover, the Division actively pursued the remaining charges, and those charges, if established, would have provided a basis for discipline under Rule 102(e). An order instituting proceedings satisfies the demands of due process if the respondent is "afford[ed] full opportunity to justify [his or her] conduct during the course of the litigation."[109] Respondents have not demonstrated how changes in the Division's presentation of its case in any way prejudiced Respondents' ability to justify their conduct; they have not pointed to any defense to the charged violations that they were prevented from raising during the hearing.[110]

4. Claimed Reputational Harm

Although Respondents claim that the institution of proceedings caused them reputational and professional harm, these claims do not give rise to due process relief unless they prejudiced the hearing process. As noted above, Respondents' attempt to extend procedural protections for adjudications to the investigation is misguided. Even if a government investigation could result

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[108] While the record does not specifically state the Division's original basis for recommending the inclusion of the Prepayment Allegations in the OIP, we note that vendor contracts containing prepayment provisions and 1998 audit workpapers initialed by Meyer referencing the review of "executed promotional contracts," "executed contracts," and "vendor contracts" could have suggested to an unbiased investigator that Meyer had, in fact, reviewed such provisions.

[109] *Flying Food Group, Inc. v. NLRB*, 471 F.3d 178, 183 (D.C. Cir. 2006) ("[P]leadings in administrative proceedings are not judged by the standards applied to an indictment at common law. . . . Rather, '[i]t is sufficient if the [petitioner] understood the issue and was afforded full opportunity to justify its conduct during the course of the litigation.'" (internal citations and punctuation omitted)); *see also Aloha Airlines, Inc. v. Civil Aeronautics Bd.*, 598 F.2d 250, 261-62 (D.C. Cir. 1979) (finding no procedural defect when the factual basis for the law judge's decision diverged from the factual allegations in the complaint because "the entire issue was fully litigated in the course of the proceedings before the ALJ and the Board"); *RFG Options Co.*, 49 S.E.C. 878, 885 (1988) (finding no prejudice where nature of charged violation changed during opening statement of the hearing).

[110] Even assuming *arguendo* that the OIP was not based on an independent judgment, Respondents "do[] not have a constitutional right to a conflict-free agency determination of whether to sue him civilly unless the conflict laps over into the trial." *Buntrock v. SEC*, 347 F.3d 995, 999 (7th Cir. 2003); *see also United States v. Oregon*, 44 F.3d 758, 772 (9th Cir. 1994) (stating that a due process claim based on allegations of a biased tribunal must at least demonstrate "an unacceptable probability of actual bias" by "the tribunal that will adjudicate [the] claims"); *United States v. Parish*, 468 F.2d 1129, 1133 (D.C. Cir. 1972) ("[T]he concern of the Due Process Clause is erosion of the accused's capability to muster his response to the charges.").

in adverse consequences, including public opprobrium, job loss, or criminal prosecution, such investigation is not subject to the same due process protections observed in proceedings adjudicating legal rights.[111]

5. Claimed Ethical Violations.

Active government deceit or affirmative misrepresentations compromising a respondent's defense at the hearing may implicate due process rights,[112] but Respondents have not demonstrated such misconduct in this case. Nor has Meyer substantiated her claim that the institution of proceedings was inconsistent with Commission ethical canons encouraging "unusually high standards of honesty, integrity, impartiality and conduct" and the "avoidance of actual or apparent misconduct or conflicts of interest," or discouraging Commission staff from "condon[ing] unprofessional conduct by attorneys."[113] Rather than condoning suspected unprofessional conduct, the Division referred suspected misconduct by Former Counsel for further investigation, and the separation of the Counsel Investigation by OGC from the investigation of Respondents' conduct by the Division reflected an institutional safeguard against inappropriate bias.[114] We note that government action is entitled to a presumption of good faith "[i]n the absence of a clear showing of bad faith,"[115] which Respondents have not made here.

The record does not support Respondents' claim that the decision not to take investigative testimony was "contrary to the Commission's long-standing commitment to fundamental fairness," particularly when taking such testimony could have fueled the type of due process challenges Respondents now raise. For instance, disclosure of the Counsel Investigation to Respondents, as Respondents contend was required, in connection with such testimony could have provoked a charge of improper interference in their relationship with Former Counsel.[116]

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111 *Hannah*, 363 U.S. at 443; *see also FTC v. Standard Oil Co.*, 449 U.S. at 244 ("[T]he expense and annoyance of litigation is part of the social burden of living under government." (internal citation omitted)).

112 *See supra* note 89.

113 17 C.F.R. §§ 200.735-2(a), 200.69.

114 *See supra* note 73.

115 *Trautman Wasserman*, 90 SEC Docket at 3105; *see also Withrow*, 421 U.S. at 47 (noting the "presumption of honesty and integrity in those serving as adjudicators"). In any case, violations of "legal or ethical rules governing [Commission] investigations" are "not, without more, a defense to the SEC's suit." *Buntrock*, 347 F.3d at 998.

116 *See Stringer*, 521 F.3d at 1201 (stating that "had the government . . . warn[ed defendant] about [his attorney's] conflict, bypassing his attorney, the government would have

(continued...)

6. Conclusion

Based on our review of Respondents' contentions, we find that Respondents have not established a violation of their due process rights. Respondents have not demonstrated that circumstances prior to the issuance of the OIP compromised their ability to defend themselves against the charged violations at the hearing.

VI.

Under all the circumstances, and based on our de novo review of the record, we have concluded that the record before us does not establish by a preponderance of the evidence that Respondents committed the offenses charged. We will accordingly dismiss this proceeding.

An appropriate order will issue.[117]

By the Commission (Chairman SCHAPIRO and Commissioners CASEY, WALTER and AGUILAR); Commissioner PAREDES concurs in the findings on the merits but believes that, as the issues addressed in Section V are moot, the opinion should not address them.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

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116 (...continued)
engaged in conduct that itself may have amounted to interference" violating defendant's due process rights).

117 We have considered all of the contentions 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. 61162 / December 14, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Rel. No. 3080 / December 14, 2009

Admin. Proc. File No. 3-12208

In the Matter of

KEVIN HALL, CPA
and
ROSEMARY MEYER, CPA

ORDER DISMISSING PROCEEDINGS

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

ORDERED that the proceedings instituted on February 16, 2006 against Kevin Hall, CPA and Rosemary Meyer, CPA, be, and they hereby are, dismissed.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2961 / December 14, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13713

In the Matter of **Stephen Jay Mermelstein,** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 203(f) 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 proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Stephen Jay Mermelstein ("Mermelstein" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings, Making Findings, and Imposing Remedial Sanctions Pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

RESPONDENT

1. **Stephen Jay Mermelstein**, age 58, resides in Warren, New Jersey. Mermelstein was a founder of Ark Asset Management Co., Inc. ("Ark") and, during the Relevant Period, was the Chief Operating Officer. Mermelstein oversaw the legal, compliance and operational aspects of Ark's advisory business.

RELEVANT ENTITIES

2. **Ark Asset Management Co., Inc.,** a New York corporation headquartered in New York, New York, was registered with the Commission as an investment adviser from August 21, 1989 through March 2, 2009, when it withdrew its registration. It was the wholly-owned, operating subsidiary of Ark Asset Holdings, Inc. ("Ark Holdings"). Ark was originally the investment management arm of Shearson Lehman Brothers Inc. Ark ceased operations on February 27, 2009 and sold substantially all of its assets. On or about March 30, 2009, Ark Holdings consented to an involuntary bankruptcy proceeding under Chapter 7 of the Bankruptcy Code.

3. **NorthStar Funds** ("Proprietary" accounts or funds) was a set of hedge funds created by Ark in 2000. In December 2003, the portfolio manager responsible for trading both NorthStar and Specialty Growth, left Ark and created a separate entity, NorthStar Capital Funds, LLC, which took over the management of the NorthStar Funds.

4. **Specialty Growth** ("Client" accounts) was a set of advisory accounts created by Ark in 1986 and managed using a growth strategy. Specialty Growth clients included large institutional investors, such as retirement plans, pension funds and charitable organizations.

SUMMARY

5. This matter involves Respondent's failure reasonably to supervise a now-deceased portfolio manager ("Portfolio Manager") who engaged in fraudulent trade allocation – "cherry-picking" – at Ark, which was a registered investment adviser. The Portfolio Manager (who died in 2005) favored the Proprietary accounts over the Client accounts in the allocation of securities between August 2000 and December 2003 ("Relevant Period"). The Portfolio Manager placed orders for securities, but changed or delayed making allocations of the purchases and sales until after the order had been filled and the price of the security had been obtained, which allowed the Portfolio Manager to allocate more favorable trades to the Proprietary accounts. As a result of this fraudulent

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

conduct, Ark realized at least $19 million of ill-gotten gains in the form of performance fees from the Proprietary accounts. Respondent was Ark's Chief Operating Officer during the Relevant Period. Respondent failed reasonably to supervise because he failed to detect and prevent the Portfolio Manager's fraud in spite of red flags indicating that the Portfolio Manager's allocation practices were questionable.

FACTS

A. Background

6. In August 2000, Ark launched a set of hedge funds, the NorthStar Funds, in which numerous Ark employees, traders, and board members invested. The Portfolio Manager made all investment decisions with respect to, and had sole trading authority over, both the Proprietary and Client accounts and was also invested in the Proprietary accounts. Both the Proprietary accounts and the Client accounts engaged in day-trading. In fact, the Proprietary funds realized most of their profits from day-trading stocks. The Portfolio Manager often traded the same securities for the Proprietary and Client accounts.

7. At the time the Proprietary funds were created and throughout the Relevant Period, Respondent, in his role as Chief Operating Officer, was directly responsible for overseeing operations and compliance at Ark, including oversight of the Portfolio Manager's trading desk.

B. The Cherry-Picking Scheme

8. At or soon after the launch of the Proprietary funds, the Portfolio Manager began to execute a cherry-picking scheme that favored the Proprietary accounts in the allocation of securities. The Portfolio Manager often changed initial allocation decisions or made allocation decisions after execution and sometimes at the end of the trading day.

9. When placing trades, neither the Portfolio Manager nor the traders who worked for him documented how the trade would ultimately be allocated between the two sets of accounts. While each set of accounts had different order tickets, orders were routinely written on an order ticket for one of the two sets of accounts. Where the order was written, however, did not reflect how the Portfolio Manager would ultimately decide to allocate the securities. Instead, after an order was filled, the Portfolio Manager would sometimes decide to keep the entire allocation with one set of accounts (i.e., the Proprietary or Client accounts), would sometimes move part of the allocation to the other set of accounts, or would sometimes decide to allocate the entire trade to the other set of accounts.

10. Profitable trades were more likely to be allocated to the Proprietary accounts than to the Specialty Growth accounts, with a difference in profitability of approximately 68% to approximately 37% respectively. Additionally, approximately 75% of the Proprietary funds' long day-trades were profitable while only approximately 37% of the Client accounts' long day-trades were profitable. Consequently, there was a significant overall

performance differential between the Proprietary accounts and the Client accounts for most of the Relevant Period.

11. Respondent knew that there was a disparity in performance between the Proprietary accounts and the Client accounts. Directors and officers, including Respondent, were informed at board meetings throughout the Relevant Period about the performance of the Client accounts. In addition, Respondent was also invested in the Proprietary funds and thus knew about the performance of the Proprietary accounts.

C. Failure to Supervise

12. Because Ark's Chairman delegated to Respondent oversight of the trading function at Ark, which included the trading activities of the Portfolio Manager and the employees who worked on the trading desk, Respondent was a supervisor of the Portfolio Manager for purposes of the Advisers Act.

13. Although Respondent understood the conflict created by the fact that the Portfolio Manager was trading for both the Proprietary and Client accounts at the same time, Respondent failed to monitor trading patterns or order tickets in order to detect any fraudulent allocations or improper trading. Respondent relied on the Portfolio Manager and his traders to self-report any improper conduct without sufficient independent verification.

14. Respondent received at least three red flags of possible wrongdoing in the allocation of securities: first, in or around 2000, the Portfolio Manager's head trader informed Respondent that the Portfolio Manager did not make allocation decisions at the time he placed orders; second, in or around 2001, the Portfolio Manager requested, and was granted, approval from the Respondent to make allocation determinations within a certain amount of time after trading orders had been placed or executed; finally, in late 2002, Respondent received and reviewed an SEC examination staff's deficiency letter concerning, among other things, possible improper allocation practices at Ark relating to initial public offerings.

15. Specifically, sometime in or around 2000, after the Portfolio Manager was already trading for both the Proprietary and Client accounts, the head trader informed Respondent that the Portfolio Manager was not making allocation determinations contemporaneously with orders.

16. In early 2001, the Portfolio Manager approached Respondent and asked for compliance approval to make allocation determinations after he placed his trading orders. Respondent's response to this red flag was to permit the Portfolio Manager to make allocation decisions within a certain amount of time after he had placed or executed his orders.

17. Finally, Respondent reviewed a Commission examination staff's letter from December 12, 2002 regarding IPO allocations. The letter suggested that the Proprietary

funds may have been favored in the allocation of IPO shares and thus was a red flag of irregularities. Ark affirmed in response to the examination staff's letter that it made changes to its compliance procedures. However, Respondent did not thereafter conduct any substantive reviews of trades, did not review order tickets or conduct any specific review with respect to allocation practices between the Proprietary accounts and the Client accounts. No new procedures were implemented after the examination concerning allocation practices.

18. Had Respondent responded reasonably to the red flags, he could have detected and prevented the fraudulent cherry-picking scheme.

VIOLATIONS

21. Section 203(e)(6) of the Advisers Act authorizes the Commission to impose sanctions against an adviser for failing reasonably to supervise, with a view to preventing violations of the provisions of the federal securities laws and rules thereunder, another person who commits such a violation, if that person is subject to the adviser's or associated person's supervision. Section 203(f) of the Advisers Act provides for sanctions against associated persons for the same conduct.

22. Liability for failure to supervise may be imposed when a supervisor fails "to learn of improprieties when diligent application of supervisory procedures would have uncovered them." *Blinder, Robinson & Co.*, Exchange Act Rel. No. 19057, 26 SEC Docket 238, 240 (Sept. 17, 1982) (supervisors who failed to supervise because they failed properly to review order tickets, which would have alerted them to possible violations). *See also Rhumbline Advisers,* Advisers Act Rel. No. 1765, 68 SEC Docket 276 (Sept. 29, 1998) (settled order) (investment adviser and principal both "failed reasonably to supervise [the trader], who was subject to their supervision within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing his violations" of the federal securities laws).

23. Respondent failed reasonably to supervise the Portfolio Manager's trading practices even though he was made aware of at least three red flags of irregularities.

24. Instead of responding to those red flags by conducting regular and vigorous reviews of order tickets, allocation spreadsheets and the timing of allocations, Respondent improperly permitted the Portfolio Manager to make allocation decisions within a certain amount of time after orders had been placed or executed. Respondent also, in spite of the red flags, relied on the Portfolio Manager and the traders to self-report without adequate independent verification. Respondent thus failed to detect the improper cherry-picking that would have been revealed by a reasonable review and monitoring of the Portfolio Manager's trading activity.

25. Accordingly, Respondent failed reasonably to supervise the Portfolio Manager, who was subject to his supervision within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing the Portfolio Manager's violations of Section

10(b) of the Exchange Act and Rule 10b-5 thereunder and the Portfolio Manager's aiding and abetting violations of Sections 206(1) and (2) of the Advisers Act.

UNDERTAKING

Respondent has undertaken to cooperate fully with the Commission in any and all investigations, litigations or proceedings relating to or arising from the matters described in the Order. In connection with such cooperation, Respondent undertakes:

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 may reasonably 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 Respondent to be conducted at deposition, hearing or trial pursuant to any notice or subpoena, Respondent:

i. Agrees that any such notice or subpoena for his appearance and testimony may be served by regular mail on his counsel, Ronald G. Blum, Manatt, Phelps & Phillips, LLP, 7 Times Square, New York, New York 10036; 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 Mermelstein's Offer.

Accordingly, pursuant to Section 203(f) of the Advisers Act:

A. **IT IS HEREBY ORDERED** that Respondent be, and hereby is, suspended from association in a supervisory capacity with any investment adviser for a period of six months, effective on the second Monday following entry of this Order.

B. **IT IS FURTHER ORDERED** that Respondent shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of $50,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, Virginia 22312; and (D) submitted under cover letter that identifies Stephen Jay Mermelstein 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 Andrew M. Calamari, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, New York, New York, 10281. Such civil money penalty may be distributed. Regardless of whether any such 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 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.

Elizabeth M. Murphy
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. 2962 / December 14, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13714

In the Matter of Ark Asset Management Co., Inc., Respondent.	ORDER INSTITUTING CEASE AND DESIST PROCEEDINGS PURSUANT TO SECTION 203(k) OF THE INVESTMENT ADVISERS ACT AND NOTICE OF HEARING

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Ark Asset Management Co., Inc. ("Ark" or "Respondent").

II.

After an investigation, the Division of Enforcement alleges that:

RESPONDENT

1. **Ark Asset Management Co., Inc.,** a New York corporation headquartered in New York, New York, was registered with the Commission as an investment adviser from August 21, 1989 through March 2, 2009, when it withdrew its registration. It was the wholly-owned, operating subsidiary of Ark Asset Holdings, Inc. ("Ark Holdings"). Ark was originally the investment management arm of Shearson Lehman Brothers Inc. Ark ceased operations on February 27, 2009 and sold substantially all of its assets. On or about March 30, 2009, Ark Holdings consented to an involuntary bankruptcy proceeding under Chapter 7 of the Bankruptcy Code.

RELEVANT ENTITIES

2. **NorthStar Funds** ("Proprietary" accounts or funds) was a set of hedge funds created by Ark in 2000, in which certain Ark employees had ownership interests.

In December 2003, the Portfolio Manager responsible for trading for both NorthStar and the Specialty Growth accounts (defined below) left Ark and created a separate entity, NorthStar Capital Funds, LLC, which took over the management of the NorthStar Funds.

3. **Specialty Growth** ("Client" accounts) was a certain set of advisory accounts created by Ark in 1986 and managed using a growth strategy. Specialty Growth clients included large institutional investors, such as retirement plans, pension funds and charitable organizations.

SUMMARY

4. These proceedings arise out of fraudulent trade allocation, disclosure and books and records violations by Ark between August 2000 and December 2003 ("Relevant Period"). During the Relevant Period, a now-deceased portfolio manager ("Portfolio Manager") of Ark engaged in fraudulent trade allocation practices – "cherry-picking" – by favoring the Proprietary accounts over the Client accounts in the allocation of securities. Ark did not disclose this scheme to its clients. As a result of this fraudulent conduct, Ark realized at least $19 million of ill-gotten gains in the form of performance fees from the Proprietary accounts. Additionally, Ark's Form ADV filings during the Relevant Period were materially misleading. Contrary to its stated goal of being "fundamentally fair" in the allocation of securities between the Proprietary and Client accounts, Ark failed to disclose to its adversely affected clients that it favored the Proprietary accounts in the allocation of securities. Ark also committed books and records violations by failing to make and keep true and accurate order memoranda.

FACTS

A. Background

5. In August 2000, Ark launched the Proprietary Funds in which numerous Ark employees, their friends and family, traders and board members invested, as well as certain outside investors. The Portfolio Manager made all investment decisions with respect to, and had sole trading authority over, both the Proprietary accounts and the Client accounts, and, along with other Ark employees, was also invested in Proprietary accounts. Both the Proprietary accounts and the Client accounts engaged in day-trading and investing in IPOs. In fact, the Proprietary funds realized most of their profits from day-trading stocks. The Portfolio Manager often traded the same securities for the Proprietary and Client accounts.

B. The Cherry-Picking Scheme

6. At or soon after the launch of the Proprietary funds, the Portfolio Manager began to execute a cherry-picking scheme that favored the Proprietary accounts in the allocation of securities. The Portfolio Manager accomplished this cherry-picking by placing orders for securities, but delaying allocation of the purchases and sales until after the order had been filled and the price of the security had been obtained. Sometimes the

Portfolio Manager did not allocate until, or made changes to allocations at, the end of the day. The Portfolio Manager allocated mostly favorable trades to the Proprietary accounts and allocated a significantly lower percentage of favorable trades to the Client accounts even though the Client accounts were legally and financially able to engage in the trades that were disproportionately allocated to the Proprietary accounts.

7. When placing trades, neither the Portfolio Manager nor the traders who worked for him documented how the trade would ultimately be allocated between the two sets of accounts. While each set of accounts had different order tickets, orders were routinely written on an order ticket for one of the two sets of accounts. The order tickets, however, did not reflect how the Portfolio Manager would ultimately decide to allocate the securities. Instead, after an order was filled, the Portfolio Manager would sometimes decide to keep the entire allocation with one set of accounts (i.e., the Proprietary or Client accounts), would sometimes move part of the allocation to the other set of accounts, or would sometimes decide to allocate the entire trade to the other set of accounts. In some instances, traders were directed to move an order from one set of accounts to the other by creating a new order ticket, transferring the security to that ticket, and discarding the old order ticket.

8. Allocations by Ark to the Proprietary accounts were much more likely to be profitable on the day of the allocation than were allocations to the Client accounts, with a difference in profitability of approximately 68% to approximately 37% respectively. Additionally, approximately 75% of Proprietary funds' long day-trades were profitable while only approximately 37% of Client accounts' long day-trades were profitable. Consequently, there was a significant overall performance differential between the Proprietary funds and the Client funds for most of the Relevant Period.

9. The cherry-picking resulted in enhanced first-day profitability (realized and unrealized gains) for the Proprietary accounts of approximately $230 million. Favorable day-trades generated approximately $81 million in profits for the Proprietary accounts during the Relevant Period.

10. The officers and directors of Ark knew about the disparity in performance between the Proprietary accounts and the Client accounts. Directors and officers were informed at board meetings throughout the Relevant Period about the performance of the Client accounts. In addition, many of Ark's officers and directors were investors in the Proprietary funds and thus knew about the performance of the Proprietary funds.

C. <u>Disclosures and Books and Records Violations</u>

11. Ark's Form ADV became materially inaccurate in 2000 when the Portfolio Manager began allocating better trades to the NorthStar accounts than the Specialty Growth accounts, either for profit or to minimize losses to the NorthStar accounts. Ark's Form ADV stated that its "goal is to be fundamentally fair on an overall basis with respect to all clients invested in [both NorthStar and Specialty Growth accounts]... ." Even though Ark filed amendments to its Form ADV between 2000 and

2003, it failed to correct the materially inaccurate statement by not disclosing that it favored NorthStar clients over Specialty Growth clients when allocating trades.

12. Moreover, Item 11 of Part I of Ark's Form ADV requires an adviser to disclose information about the disciplinary record of the adviser and its advisory affiliates – which include persons who are controlled by the adviser. The head trader for both the Proprietary and Client accounts was controlled by Ark and was listed as a "control person" on Ark's Form ADV. In June 2003, that head trader, who was under investigation by the New York Stock Exchange at the time Ark hired him in 2000, settled with the NYSE and consented to a censure and a fine. Ark did not amend its disclosure to reflect this disciplinary action in response to Item 11 of Part I of its Form ADV.

13. Finally, Ark failed to make and keep accurate order tickets that reflected allocation determinations contemporaneous with the order, failed to make and keep accurate memoranda showing modifications or cancellations of certain orders, discarded certain order tickets, and altered order memoranda after execution of orders.

VIOLATIONS

14. By knowingly or recklessly allocating profitable trades to the Proprietary accounts at the expense of the Client accounts and not disclosing this scheme to clients, Ark violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibits fraudulent conduct in connection with the purchase or sale of securities. In addition, through this cherry-picking scheme and by failing to disclose the scheme, Ark violated Sections 206(1) and 206(2) of the Advisers Act, which, in pertinent part, prohibit investment advisers from employing any device, scheme, or artifice to defraud any client and from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client.

15. Ark engaged in a scheme to defraud by allocating profitable trades to the Proprietary accounts at the expense of the Client accounts without disclosing this practice. As an investment adviser, and therefore a fiduciary, Ark had an affirmative duty of loyalty not to put its interests ahead of its clients and to disclose material information to its clients. However, during the relevant period, Ark failed to disclose to the adversely affected clients that Ark was favoring the hedge funds when allocating trades. Accordingly, Ark violated Sections 206(1) and (2) of the Advisers Act.

16. Ark's Form ADV became materially misleading in 2000 when the Portfolio Manager began allocating better trades to the Proprietary accounts than the Client accounts, either for profit or to minimize losses to the Proprietary accounts. Ark failed to amend the form, as required by Section 204 of the Advisers Act and Rule 204-1(a)(2) thereunder. Ark's Form ADV stated that its "goal is to be fundamentally fair on an overall basis with respect to all clients invested in [both the Proprietary and Client accounts]... ." Ark failed to correct the materially inaccurate statement by not disclosing that it favored the Proprietary funds over the Client accounts in the allocation of

securities. Accordingly, Ark violated Section 204 of the Advisers Act and Rule 204-1(a)(2) thereunder.

17. Ark also failed to file an amendment to Item 11 of Part I of Form ADV, which requires an adviser to disclose information about the disciplinary record of the adviser and its advisory affiliates – which include persons who are controlled by the adviser. The head trader for both sets of accounts was controlled by Ark and was listed as a "control person" on Ark's Form ADV. Therefore Ark was obligated to amend Item 11 to disclose that an investigation of the head trader by the New York Stock Exchange resulted in a settlement in which the head trader consented to a censure and fine in June 2003. Accordingly, Ark violated Sections 204 and 207 of the Advisers Act and Rule 204-1(a)(2) thereunder.

18. Ark violated Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder which requires registered investment advisers to make and keep true, accurate and current order memoranda for the purchase and sale of any security on behalf of a client by failing to make accurate order tickets that contained all the information required by those rules. Ark's order tickets failed to reflect and/or inaccurately reflected the "terms and conditions" of certain orders in violation of these Rules. Specifically, Ark failed to make and keep accurate memoranda showing modifications or cancellations of certain orders, discarded certain order tickets, and altered order memoranda after execution of orders. Accordingly, Ark violated Section 204 of the Advisers Act and Rule 204-2(a)(3) thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it appropriate and in the public interest that cease-and-desist proceedings be instituted to determine:

1. Whether the allegations set forth in Section II are true and, in connection therewith, to afford Ark an opportunity to establish any defenses to such allegations; and

2. What, if any, remedial action is appropriate in the public interest against Ark pursuant to Section 203(k) of the Advisers Act, including disgorgement.

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 not earlier than 30 days nor later than 60 days after service of the notice 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 the Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. §201.220.

If the Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon the Respondent personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61164; File No. S7-06-09)

December 14, 2009

ORDER EXTENDING AND MODIFYING TEMPORARY EXEMPTIONS UNDER THE SECURITIES EXCHANGE ACT OF 1934 IN CONNECTION WITH REQUEST OF CHICAGO MERCANTILE EXCHANGE INC. RELATED TO CENTRAL CLEARING OF CREDIT DEFAULT SWAPS, AND REQUEST FOR COMMENTS

I. Introduction

Over the past year, the Securities and Exchange Commission ("Commission") has taken multiple actions to protect investors and ensure the integrity of the nation's securities markets, including actions[1] designed to address concerns related to the market in credit default swaps ("CDS").[2] The over-the-counter ("OTC") market for CDS has been a source of concern to us

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1 See generally Securities Exchange Act Release No. 60372 (Jul. 23, 2009), 74 FR 37748 (Jul. 29, 2009) (temporary exemptions in connection with CDS clearing by ICE Clear Europe Limited), Securities Exchange Act Release No. 60373 (Jul. 23, 2009), 74 FR 37740 (Jul. 29, 2009) (temporary exemptions in connection with CDS clearing by Eurex Clearing AG), Securities Exchange Act Release No. 59578 (Mar. 13, 2009), 74 FR 11781 (Mar. 19, 2009) (temporary exemptions in connection with CDS clearing by Chicago Mercantile Exchange Inc.) ("CME Exemptive Order"), Securities Exchange Act Release No. 59527 (Mar. 6, 2009), 74 FR 10791 (Mar. 12, 2009) (temporary exemptions in connection with CDS clearing by ICE US Trust LLC (now "ICE Trust U.S. LLC")), Securities Exchange Act Release No. 59164 (Dec. 24, 2008), 74 FR 139 (Jan. 2, 2009) (temporary exemptions in connection with CDS clearing by LIFFE A&M and LCH.Clearnet Ltd.) and other Commission actions discussed therein.

In addition, we have issued interim final temporary rules that provide exemptions under the Securities Act of 1933 and the Securities Exchange Act of 1934 for CDS to facilitate the operation of one or more central counterparties for the CDS market. See Securities Act Release No. 8999 (Jan. 14, 2009), 74 FR 3967 (Jan. 22, 2009) (initial approval); Securities Act Release No. 9063 (Sep. 14, 2009), 74 FR 47719 (Sep. 17, 2009) (extension until Nov. 30, 2010).

Further, the Commission has provided temporary exemptions in connection with Sections 5 and 6 of the Securities Exchange Act of 1934 for transactions in CDS. See Securities Exchange Act Release No. 59165 (Dec. 24, 2008), 74 FR 133 (Jan. 2, 2009) (initial exemption); Securities Exchange Act Release No. 60718 (Sep. 25, 2009), 74 FR 50862 (Oct. 1, 2009) (extension until Mar. 24, 2010).

2 A CDS is a bilateral contract between two parties, known as counterparties. The value of this financial contract is based on underlying obligations of a single entity ("reference entity") or on a particular security or other debt obligation, or an index of several such entities, securities, or obligations. The obligation of a seller to make payments under a CDS contract is triggered by a default or other credit event as to such entity or entities or such security or securities. Investors may use CDS for a variety of reasons, including to offset or insure against risk in their fixed-income portfolios, to take positions in

and other financial regulators, and we have recognized that facilitating the establishment of central counterparties ("CCPs") for CDS can play an important role in reducing the counterparty risks inherent in the CDS market, and thus can help mitigate potential systemic impacts. We have therefore found that taking action to help foster the prompt development of CCPs, including granting temporary conditional exemptions from certain provisions of the federal securities laws, is in the public interest.[3]

The Commission's authority over the OTC market for CDS is limited. Specifically, Section 3A of the Securities Exchange Act of 1934 ("Exchange Act") limits the Commission's authority over swap agreements, as defined in Section 206A of the Gramm-Leach-Bliley Act.[4] For those CDS that are swap agreements, the exclusion from the definition of security in Section 3A of the Exchange Act, and related provisions, will continue to apply. The Commission's action today does not affect these CDS, and this Order does not apply to them. For those CDS that are not swap agreements ("non-excluded CDS"), the Commission's action today provides conditional exemptions from certain requirements of the Exchange Act.

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bonds or in segments of the debt market as represented by an index, or to take positions on the volatility in credit spreads during times of economic uncertainty.

Growth in the CDS market has coincided with a significant rise in the types and number of entities participating in the CDS market. CDS were initially created to meet the demand of banking institutions looking to hedge and diversify the credit risk attendant to their lending activities. However, financial institutions such as insurance companies, pension funds, securities firms, and hedge funds have entered the CDS market.

3 See generally actions referenced in note 1, supra.

4 15 U.S.C. 78c-1. Section 3A excludes both a non-security-based and a security-based swap agreement from the definition of "security" under Section 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10). Section 206A of the Gramm-Leach-Bliley Act defines a "swap agreement" as "any agreement, contract, or transaction between eligible contract participants (as defined in section 1a(12) of the Commodity Exchange Act. . .) . . . the material terms of which (other than price and quantity) are subject to individual negotiation." 15 U.S.C. 78c note.

The Commission believes that using well-regulated CCPs to clear transactions in CDS provides a number of benefits, by helping to promote efficiency and reduce risk in the CDS market and among its participants, contributing generally to the goal of market stability, and by requiring maintenance of records of CDS transactions that would aid the Commission's efforts to prevent and detect fraud and other abusive market practices.[5]

Earlier this year, the Commission granted temporary conditional exemptions to the Chicago Mercantile Exchange Inc. ("CME") and Citadel Investment Group, L.L.C. ("Citadel") from certain requirements under the Exchange Act with respect to their proposed activities in clearing and settling certain CDS,[6] as well as the proposed activities of certain other persons.[7] Those exemptions are scheduled to expire on December 14, 2009. CME has requested that the Commission extend the exemptions, and expand them to address the calculation of settlement prices for non-excluded CDS.[8]

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5 See generally actions referenced in note 1, supra.

6 For purposes of this Order, "Cleared CDS" means a credit default swap that is submitted (or offered, purchased, or sold on terms providing for submission) to CME, that is offered only to, purchased only by, and sold only to eligible contract participants (as defined in Section 1a(12) of the Commodity Exchange Act ("CEA") as in effect on the date of this Order (other than a person that is an eligible contract participant under paragraph (C) of that section)), and in which: (i) the reference entity, the issuer of the reference security, or the reference security is one of the following: (A) an entity reporting under the Exchange Act, providing Securities Act Rule 144A(d)(4) information, or about which financial information is otherwise publicly available; (B) a foreign private issuer whose securities are listed outside the United States and that has its principal trading market outside the United States; (C) a foreign sovereign debt security; (D) an asset-backed security, as defined in Regulation AB, issued in a registered transaction with publicly available distribution reports; or (E) an asset-backed security issued or guaranteed by the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), or the Government National Mortgage Association ("Ginnie Mae"); or (ii) the reference index is an index in which 80 percent or more of the index's weighting is comprised of the entities or securities described in subparagraph (i). As discussed above, the Commission's action today does not affect CDS that are swap agreements under Section 206A of the Gramm-Leach-Bliley Act. See text at note 4, supra.

7 See CME Exemptive Order, supra note 1.

8 See Letter from Ann K. Shuman, Managing Director and Deputy General Counsel, CME, to Elizabeth Murphy, Secretary, Commission, Dec. 14, 2009 ("December 2009 request").

Based on the facts presented and the representations made by CME,[9] and for the reasons discussed in this Order, and subject to certain conditions, the Commission is extending temporarily the exemptions granted in the CME Exemptive Order, and is expanding them to accommodate CME's proposed settlement price calculation methodology for non-excluded CDS. Specifically, the Commission is extending the temporary conditional exemption granted to CME from clearing agency registration under Section 17A of the Exchange Act solely to perform the functions of a clearing agency for certain non-excluded CDS transactions. The Commission also is extending the temporary exemption for eligible contract participants and others from certain Exchange Act requirements with respect to non-excluded CDS cleared by CME. In addition, this order conditionally exempts on a temporary basis CME and certain of its clearing members from the registration requirements of Sections 5 and 6 of the Exchange Act solely in connection with the calculation of settlement prices for non-excluded CDS cleared by CME. These exemptions are temporary, subject to certain conditions, and will expire on March 31, 2010.

II. Discussion

A. Description of CME Proposal

The exemptive request by CME describes how its proposed arrangements for central clearing of CDS would operate, and makes representations about the safeguards associated with those arrangements, as described below:

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[9] See id. The exemptions we are granting today are based on all of the representations made in the December 2009 request by CME. We recognize, however, that there could be legal uncertainty in the event that one or more of the underlying representations were to become inaccurate. Accordingly, if any of these exemptions were to become unavailable by reason of an underlying representation no longer being materially accurate, the legal status of existing open positions in non-excluded CDS that previously had been cleared pursuant to the exemptions would remain unchanged, but no new positions could be established pursuant to the exemptions until all of the underlying representations were again accurate.

1. CME Organization

CME Group Inc. ("CME Group"), a Delaware stock corporation, is the holding company for CME, as well as Board of Trade of the City Of Chicago, Inc., New York Mercantile Exchange, Inc., Commodity Exchange, Inc., and their subsidiaries.

CME is a designated contract market ("DCM"), regulated by the Commodity Futures Trading Commission ("CFTC"), for the trading of futures and options on futures contracts. In addition, CME Group operates its own clearing house, which is a division of CME. The CME clearing house is a derivatives clearing organization ("DCO") regulated by the CFTC. The clearing house clears, settles, and guarantees the performance of all transactions matched through the execution facilities and on third party exchanges for which CME Group provides clearing services. The clearing house operates with the oversight of the Clearing House Risk Committee ("CHRC"). The CHRC is made up of a group of clearing member representatives who represent the interests of the clearing house as well as clearing members of CME Group. With respect to CDS clearing services, CME is establishing three additional committees:[10] (i) a CDS Advisory Board, which will have oversight for certain aspects of CME's CDS clearing services; (ii) a CDS Determinations Committee, which will be responsible for issuing determinations related to CDS contract terms; and (iii) a CDS Default Management Committee, which will advise the clearing house on matters relating to managing CDS portfolio positions in the event of an actual or threatened default involving CDS cleared contracts.

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10 These committees will generally have equal authority to the CHRC, but with narrower mandates and oversight that is specific to CDS. In some cases, the approval of the new CDS Advisory Board will be required, in addition to the approval of the CHRC, with respect to certain changes to CME's risk management of CDS. The CDS Advisory Board will also have approval rights with respect to certain other matters, such as the launch of clearing services for a new CDS product using the existing CDS financial safeguards package.

CME is required to comply with the eighteen CFTC Core Principles applicable to registered DCMs and the fourteen CFTC Core Principles applicable to DCOs.[11] The CFTC conducts regular audits or risk reviews of CME with respect to these Core Principles. CME is registered and in good standing with the CFTC. In addition, CME is notice registered with the Commission as a special purpose national securities exchange for the purpose of trading security futures products. In the U.K., CME is a Recognised Overseas Investment Exchange and a Recognised Overseas Clearing House, subject to regulation by the U.K. Financial Services Authority.

2. CME Central Counterparty Services for CDS

CME as part of its clearing services will be interposed as central counterparty for transactions in Cleared CDS. CME will provide clearing and settlement services for multiple platforms, including an electronic trade booking and migration platform operated by CME.[12] Specifically, CME will accept for clearing both (i) pre-existing non-standard trades that are submitted to clearing through CME's migration utility, a platform that provides data for converting non-standard terms to standard terms, allowing parties to non-standard transactions to substitute standard transactions for non-standard and submit the standard for clearing,[13] and (ii)

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[11] The DCM and DCO Core Principles are set forth in 7 U.S.C. 7(b), 7a-1(c)(2)(A).

[12] CME's clearing services would be available only to persons that satisfy the definition of an "eligible contract participant" in Section 1a(12) of the CEA (other than paragraph (C) thereof). In addition, each participant must be a clearing member of CME or have a clearing relationship with a CME clearing member that agrees to assume responsibility for the participant's CDS contracts cleared by CME. Initially, CME would offer CDS that mirror as closely as possible the terms of existing OTC CDS. The coupons and maturities would be standardized to the extent necessary to permit centralized clearing.

[13] Non-standard trades that are migrated to CME would ultimately be converted to a standard, centrally cleared contract. Migration may only occur if both counterparties to a trade agree to the process and both are clearing members or have the appropriate relationship with a clearing member. To facilitate operational efficiency, CME would also supply participants a data file of the original bilateral positions that were accepted into clearing via the migration process, so that participants may send appropriate exit records to the DTCC Trade Information Warehouse.

transactions executed on standardized terms, which can be submitted to CME for clearing using CME's trade booking facility or a confirmation service.[14]

CME has no rule requiring an executing dealer to be a clearing member. In addition, CME will adopt a rule to confirm that there will be open access to its CDS clearing services for any execution venue or trade processing or confirmation service that desires to facilitate the submission of CDS transactions to CME for clearing, subject to CME's normal operational requirements applied to all such third-party services, including the requirement for a CME clearing member guaranty of all transactions submitted to clearing.

CME clearing and settlement of Cleared CDS will operate using the established systems, procedures, and financial safeguards that stand behind trading in CME's primary futures market, and such activities will be subject to CFTC oversight of risk management and collateralization procedures. CME Rulebook Chapter 8-F sets forth the rules governing clearing and settlement of all products, instruments, and contracts in OTC derivatives, including but not limited to CDS contracts, swaps, and forward rate agreements that the CME clearinghouse has designated as eligible for clearing.

3. CME Risk Management

CME clearing members that are broker-dealers or futures commission merchants ("FCMs") maintain capital and liquidity in accordance with relevant SEC and CFTC rules and regulations, respectively. In addition, CME has requirements for minimum capital contribution, contribution to the guaranty fund based on risk factors, maintenance margin, and mark to market with immediate payment of losses applicable to clearing member firms.

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[14] Trades may be submitted using Bloomberg's VCON confirmation service as of the initial launch date. CME is also working with other confirmation services to connect to CME clearing for submission of CDS transactions. See December 2009 request, supra note 8.

CME has adopted a risk-based capital requirement. Capital requirements are monitored by CME's Audit Department and vary to reflect the risk of each clearing member's positions as well as CME's assessment of each clearing member's internal controls, risk management policies, and back office operations. CME has established additional capital and guaranty fund contribution requirements for clearing members authorized to clear CDS. To clear CDS, whether for proprietary or customer accounts, a clearing member must maintain $500 million in adjusted net capital.[15] CDS clearing members must also make initial guaranty fund contributions with respect to CDS that will be a minimum of $50 million each.[16] Those CDS clearing members with adjusted net capital of less than $1 billion must also maintain excess margin with the clearing house that is equal to their guaranty fund contributions; CDS clearing members with less than $5 billion in adjusted net capital are also subject to daily capital reporting.

Clearing members also have to manage appropriate requirements with respect to their customers. CME Rule 982 requires clearing members to establish written risk management policies and procedures, including monitoring the risks assumed by specific customers. To facilitate such controls with respect to CDS transactions, CME's clearing systems includes functionality that permits clearing members to register customer accounts and specify customer credit limits.

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15 CDS clearing members that are structured as hedge funds must also have a minimum of $5 billion in net assets under management.

16 During an initial phase starting as early as December 15, 2009, a limited number of CDS clearing members and customers that have been engaged in active testing with CME will be eligible to participate, and participating clearing members will make guaranty fund contributions of $50 million each. Clearing will be restricted to a small set of index products, and CME will carefully limit risk exposures. Thereafter, participation will be open to all eligible clearing members and market participants. At that time, the minimum initial or additional guaranty fund contribution per CDS clearing member will be equal to the greater of $50 million or $500 million divided by the total number of CDS clearing members.

Customer account reporting will allow CME to view the positions held by individual accounts. Clearing members will be required to register their proprietary and customer accounts in CME's EDB system, and report new customer positions through EDB on an ongoing basis. Changes in positions of each account will be analyzed throughout the day, and compared to intraday price movements, to monitor any accounts that may develop significant losses due to market moves. In addition, significant changes in positions from day to day will be analyzed and reported to CME clearing house senior management.

In designing its margining methodology for CDS, CME conducted extensive testing of historical CDS data, stress testing the different CDS margin factors to capture moves beyond the 99% standard on its multi-factor risk model. The overall financial safeguards package for CDS has also been designed using concentration types of margining and routine stress testing. On an ongoing basis, CME will daily back-test the CDS margin factor parameters to ensure that they are providing the desired level of coverage. CME will also review on a daily basis the margin collected by CME on CDS portfolios and compare those amounts to next-day market moves so that actual portfolio effects can be determined and gauged against the margin coverage. In addition, CME will evaluate the concentration of CDS positions beyond the margin factors and compare them against overall open interest and liquidity in the CDS market.

CME will extend its scenario-based stress testing techniques for concentration margining to Cleared CDS. The concentration stress test results will be evaluated relative to excess adjusted net capital for each segregated pool. If the hypothetical losses exceed the excess adjusted net capital for a clearing member's segregated pool, then an additional margin charge will be applied to the clearing member's position. The additional margin charge will be calculated based on the magnitude of the hypothetical losses in excess of the clearing member's excess adjusted net capital.

CME determines the acceptability of different collateral types and determines appropriate haircuts.[17] Collateral requirements for Cleared CDS will appropriately reflect the specific risks of Cleared CDS, including jump-to-default and the consequences of a liquidity event caused by the defaults.

4. Settlement Prices

CME will determine settlement prices each business day for each eligible product based upon pricing data from multiple origins. Sources of pricing data will include: (1) prices of OTC transactions submitted to CME for clearing; (2) indicative settlement prices contributed by CME CDS clearing members; and (3) pricing information licensed by CME from other third-party sources. The pricing data will be processed using standard validation, aggregation, and valuation analytics. Updated settlement prices will be made available to clearing members on their open positions on a regular basis (at least once a day, or more frequently in case of sudden market moves). As part of the CDS clearing process, CME will periodically require CDS clearing members to trade at prices generated by their indicative settlement prices where those indicative settlement prices generate crossed bids and offers, pursuant to CME's price quality auction methodology.[18]

5. Member Default

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17 A list of acceptable collateral and applicable haircuts is available at www.cme.com.

18 Each trading day CME will randomly select 5% of its CDS product available for clearing (but at least one product) and will randomly select one tenor for each such product to evaluate for crossed bids and offers pursuant to CME's price quality auction methodology.

If a clearing member is troubled (i.e., if it fails to meet minimum financial requirements or its financial or operational condition may jeopardize the integrity of the CME, or negatively impact the financial markets), CME may take action pursuant to CME Rule 974 (Failure to Meet Minimum Financial Requirements) or 975 (Emergency Financial Conditions). In the event of a default by a clearing member of CME, the process would be governed by applicable CME rules.[19]

In the event of a member default, CME may access its financial safeguards package as necessary. CME's financial safeguard package is a combination of each clearing member's collateral on deposit to support its positions, the collateral of its customers to support their positions, CME surplus funds, security deposits, and CME's assessment powers.[20]

6. Customer Rules and Other Requirements

Prior to any issuance of an order from the CFTC under Section 4d of the CEA ("4d order"), described below, all Cleared CDS submitted to CME for clearing for the account of a clearing member's customer must be assigned and held in an account subject to CFTC Regulation 30.7.[21] Regulation 30.7 requires customer positions and property to be separately

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[19] See, e.g., CME Rulebook Chapter 8-F (Over-the-Counter Derivative Clearing), including but not limited to Rules 8F06 (Clearing Member Default), 8F07 (Guaranty Fund Deposit), 8F13 (Insolvency and Liquidation), and 8F25 (Default Management Committee). Chapter 8-F further incorporates the general CME Rules relating to defaults, including but not limited to Rules 802 (Protection of Clearing House), 913 (Withdrawal From Clearing Membership), 974 (Failure to Meet Minimum Financial Requirements), 975 (Emergency Financial Conditions), 976 (Suspension of Clearing Members), 978 (Open Trades of Suspended Clearing Members), and 979 (Suspended or Expelled Clearing Members).

[20] CME indicates that, excluding performance bond collateral supporting open positions, which totals approximately $85 billion, the total financial safeguards package is greater than $7.5 billion, comprised of: (1) CME surplus funds of $177 million; (2) clearing member security deposits of approximately $1.973 billion; and (3) assessment powers of approximately $5.426 billion (as of September 30, 2009). Clearing members that clear Cleared CDS would be subject to additional guaranty fund deposit requirements. Furthermore, the calculation of that portion of a clearing member's security deposit that is related to the risk of its CDS position would be scaled upward by a factor of four.

[21] 17 CFR 30.7.

held and accounted for from the positions and property of the FCM, and customer property to be deposited under an account name that clearly identifies it as customer property. CME Rule 8F03 also provides that "[a]ll collateral deposited as performance bond to support positions in such Regulation § 30.7 account and all positions, collateral or cash in such account shall be segregated from the Clearing Member's proprietary account."[22] CME notes, however, that "[n]either the CFTC nor the courts have issued an interpretation with regard to the bankruptcy protections that would be afforded to customers clearing OTC positions in 30.7 accounts, and it is therefore unclear whether they would receive the same protections as foreign futures customers."[23]

In the event the CFTC issues a 4d order,[24] the segregation and protection of customer funds and property would be controlled by Section 4d of the CEA and the related regulations; all funds and property received from customers of FCMs in connection with purchasing, selling, or holding CDS positions would be subject to the requirements of CFTC Regulation 1.20, et seq. promulgated under Section 4d. This regulation requires that customer positions and property be separately accounted for and segregated from the positions and property of the FCM. Customer property would be deposited under an account name that clearly identifies it as such and shows it is appropriately segregated as required by the CEA and Regulation 1.20, et seq.

In addition, customer margin requirements for a broker-dealer are generally set by the broker-dealer's self-regulatory organizations (e.g., the Financial Industry Regulatory Authority,

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22 As discussed below, the exemptions related to CDS customer clearing require CME clearing members to satisfy additional conditions, including conditions specific to the use of a 30.7 account.

23 December 2009 request, supra note 8.

24 CME petitioned the CFTC on June 15, 2009 for a 4d order covering cleared CDS transactions. See December 2009 request, supra note 8. More specifically, CME's petition requested that the CFTC issue an Order pursuant to Section 4d that would permit CME and its clearing members that are FCMs to commingle customer funds used to margin, secure, or guarantee CDS cleared by CME with other funds held in segregated accounts maintained in accordance with Section 4d of the CEA and CFTC regulations. See http://www.cftc.gov/stellent/groups/public/@requestsandactions/documents/ifdocs/cme4requestcds.pdf.

or FINRA). One purpose for customer margin requirements is to assure that broker-dealers collect sufficient margin from customers to protect the broker-dealer in the event that an adverse price move causes a customer default, leaving the broker-dealer with responsibility for the transaction. FINRA has amended its customer margin rule to implement an interim pilot program with respect to margin requirements for transactions in CDS.[25]

B. Extended Temporary Conditional Exemption from Clearing Agency Registration Requirement

On March 13, 2009, in connection with its efforts to facilitate the establishment of one or more CCPs for Cleared CDS, the Commission issued the CME Exemptive Order, conditionally exempting CME from clearing agency registration under Section 17A of the Exchange Act on a temporary basis.[26] Subject to the conditions in that Order, CME is permitted to act as a CCP for Cleared CDS by novating trades of non-excluded CDS that are securities and generating money and settlement obligations for participants without having to register with the Commission as a clearing agency. The CME Exemptive Order expires on December 14, 2009. Pursuant to its authority under Section 36 of the Exchange Act,[27] for the reasons described herein, the Commission is extending the exemption granted in that order until March 31, 2010, subject to certain conditions.

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25 See Securities Exchange Act No. 60722 (Sept. 25, 2009), 74 FR 50856 (Oct. 1, 2009) (File No. SR-FINRA-2009-063) (extending the implementation of FINRA Rule 4240, Margin Requirements for Credit Default Swaps, to Nov. 30, 2010).

26 See supra, note 1.

27 15 U.S.C. 78mm. Section 36 of the Exchange Act authorizes the Commission to conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of the Exchange Act or any rule or regulation thereunder, by rule, regulation, or order, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

In the CME Exemptive Order, the Commission recognized the need to ensure the prompt establishment of CME as a CCP for CDS transactions. The Commission also recognized the need to ensure that important elements of Section 17A of the Exchange Act, which sets forth the framework for the regulation and operation of the U.S. clearance and settlement system for securities, apply to the non-excluded CDS market. Accordingly, the temporary exemption in the CME Exemptive Order was subject to a number of conditions designed to enable Commission staff to monitor CME's clearance and settlement of CDS transactions.[28]

The temporary exemption was based, in part, on CME's representation that it met the standards set forth in the Committee on Payment and Settlement Systems ("CPSS") and International Organization of Securities Commissions ("IOSCO") report entitled: Recommendation for Central Counterparties ("RCCP").[29] The RCCP establishes a framework that requires a CCP to have: (i) the ability to facilitate the prompt and accurate clearance and settlement of CDS transactions and to safeguard its users' assets; and (ii) sound risk management, including the ability to appropriately determine and collect clearing fund and monitor its users' trading. This framework is generally consistent with the requirements of Section 17A of the Exchange Act.

The Commission believes that continuing to facilitate the central clearing of CDS transactions – including customer CDS transactions – through a temporary conditional exemption from Section 17A would provide important risk management and systemic benefits by facilitating the prompt establishment of CCP clearance and settlement services. Accordingly,

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28 See Securities Exchange Act Release No. 59527 (Mar. 6, 2009), 74 FR 10791 (Mar. 12, 2009).

29 The RCCP was drafted by a joint task force ("Task Force") composed of representative members of IOSCO and CPSS and published in November 2004. The Task Force consisted of securities regulators and central bankers from 19 countries and the European Union. The U.S. representatives on the Task Force included staff from the Commission, the Federal Reserve Board, and the CFTC.

and consistent with our findings in the CME Exemptive Order, we find pursuant to Section 36 of the Exchange Act that it is necessary and appropriate in the public interest and is consistent with the protection of investors for the Commission to extend, until March 31, 2010, CME's exemption provided from the clearing agency registration requirements of Section 17A, subject to certain conditions.

In granting this exemption, we are balancing the aim of facilitating CME's service as a CCP for non-excluded CDS transactions with ensuring that important elements of Commission oversight are applied to the non-excluded CDS market. The continued use of temporary exemptions will permit the Commission to continue to develop direct experience with the non-excluded CDS market. During the extended exemptive period, the Commission will continue to monitor closely the impact of the CCPs on this market. In particular, the Commission will seek to assure itself that CME has sufficient risk management controls in place and does not act in an anticompetitive manner or indirectly facilitate anticompetitive behavior with respect to fees charged to members, the dissemination of market data, and the access to clearing services by independent CDS exchanges or CDS trading platforms.

This temporary extension of the CME Exemptive Order also is designed to assure that – as CME has represented – information will be available to market participants about the terms of the CDS cleared by CME, the creditworthiness of CME or any guarantor, and the clearance and settlement process for the CDS.[30] The Commission believes operation of CME consistent with the conditions of the Order will facilitate the availability to market participants of information

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30 The Commission believes that it is important in the CDS market, as in the securities market generally, that parties to transactions have access to financial information that would allow them to evaluate appropriately the risks relating to a particular investment and make more informed investment decisions. See generally Policy Statement on Financial Market Developments, The President's Working Group on Financial Markets, March 13, 2008, available at: http://www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf.

that should enable them to make better informed investment decisions and better value and evaluate their Cleared CDS and counterparty exposures relative to a market that is not centrally cleared.

This temporary extension of the CME Exemptive Order is subject to a number of conditions that are designed to enable Commission staff to monitor CME's clearance and settlement of CDS transactions and help reduce risk in the CDS market. These conditions require that CME: (i) make available on its Web site its annual audited financial statements; (ii) preserve records related to the conduct of its Cleared CDS clearance and settlement services for at least five years (in an easily accessible place for the first two years); (iii) provide information relating to its Cleared CDS clearance and settlement services to the Commission and provide access to the Commission to conduct on-site inspections of facilities, records, and personnel related to its Cleared CDS clearance and settlement services; (iv) notify the Commission on a monthly basis about material disciplinary actions taken against any of its members utilizing its Cleared CDS clearance and settlement services, and about the involuntary termination of the membership of an entity that is utilizing CME's Cleared CDS clearance and settlement services; (v) provide the Commission with changes to rules, procedures, and any other material events affecting its Cleared CDS clearance and settlement services not less than one day prior to effectiveness or implementation of such rule changes, or in exigent circumstances, as promptly as reasonably practicable under the circumstances; (vi) provide the Commission with reports prepared by independent audit personnel that are generated in accordance with risk assessment of the areas set forth in the Commission's Automation Review Policy Statements[31] and its annual

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[31] See Automated Systems of Self-Regulatory Organization, Exchange Act Release No. 27445 (Nov. 16, 1989), File No. S7-29-89, and Automated Systems of Self-Regulatory Organization (II), Exchange Act Release No. 29185 (May 9, 1991), File No. S7-12-91.

audited financial statements prepared by independent audit personnel; and (vii) report all significant systems outages to the Commission within specified timeframes.

In addition, this temporary extension of the CME Exemptive Order is conditioned on CME, directly or indirectly, making available to the public on terms that are fair and reasonable and not unreasonably discriminatory: (i) all end-of-day settlement prices and any other prices with respect to Cleared CDS that CME may establish to calculate settlement variation or margin requirements for CME clearing members; and (ii) any other pricing or valuation information with respect to Cleared CDS as is published or distributed by CME.

As a CCP, CME will collect and process information about CDS transactions, prices, and positions from all of its participants. With this information, it will calculate and disseminate current values for open positions for the purpose of setting appropriate margin levels. The availability of such information can improve fairness, efficiency, and competitiveness of the market – all of which enhance investor protection and facilitate capital formation. Moreover, with pricing and valuation information relating to Cleared CDS, market participants would be able to derive information about underlying securities and indexes. This may improve the efficiency and effectiveness of the securities markets by allowing investors to better understand credit conditions generally.

C. Temporary Conditional Exemption from Exchange Registration Requirements

CME has requested that the Commission expand its exemptive relief to include a temporary conditional exemption for CME from the requirements of Sections 5 and 6 of the Exchange Act, and the rules and regulations thereunder, in connection with CME's methodology for determining CDS settlement prices, including its price quality auction methodology. Section 5 of the Exchange Act contains certain restrictions relating to the registration of national securities exchanges,[32] while Section 6 provides the procedures for registering as a national securities exchange.[33]

The temporary exemption would facilitate the establishment of CME's settlement price process. CME represents that updated settlement prices will be made available to clearing members on their open positions on a regular basis (at least once a day, or more frequently in case of sudden market moves). As part of the CDS clearing process, CME will periodically require CDS clearing members to trade at prices generated by their indicative settlement prices where those indicative settlement prices generate crossed bids and offers, pursuant to CME's price quality auction methodology.[34]

As discussed above, we have found in general that it is necessary or appropriate in the public interest, and is consistent with the protection of investors, to facilitate CDS clearing by CME. Consistent with that finding – and in reliance on CME's representation that the settlement pricing process, including the periodically required trading, is part of its clearing process– we further find that it is necessary or appropriate in the public interest, and is consistent with the protection of investors to grant, pursuant to Section 36 of the Exchange Act, a temporary exemption until March 31, 2010, to CME from Sections 5 and 6 of the Exchange Act in

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32 In particular, Section 5 provides:

> It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange . . . to effect any transaction in a security, or to report any such transactions, unless such exchange (1) is registered as a national securities exchange under section 6 of [the Exchange Act], or (2) is exempted from such registration . . . by reason of the limited volume of transactions effected on such exchange.... .

15 U.S.C. 78e.

33 15 U.S.C. 78f. Section 6 of the Exchange Act also sets forth various requirements to which a national securities exchange is subject.

34 See note 18, supra.

connection with its calculation of settlement variation prices for open positions in Cleared CDS, and a temporary exemption to CME clearing members from Section 5 with respect to such trading activity, subject to certain conditions.

The temporary exemption for CME is subject to three conditions. First, CME must report the following information with respect to its determination of daily settlement prices for cleared CDS to the Commission within 30 days of the end of each quarter, and preserve such reports for as long as CME offers CDS clearing services and for a period of at least five years thereafter:

- The total dollar volume of CDS transactions executed during the quarter pursuant to CME's price quality auction methodology, broken down by reference entity, security, or index; and
- The total unit volume or notional amount executed during the quarter pursuant to CME's price quality auction methodology, broken down by reference entity, security, or index.

Reporting of this information will assist the Commission in carrying out its responsibility to supervise and regulate the securities markets.

Second, CME must establish and maintain adequate safeguards and procedures to protect participants' confidential trading information related to Cleared CDS. Such safeguards and procedures shall include: (a) limiting access to the confidential trading information of participants to those CME employees who have a need to access such information in connection with the provision of CME CDS clearing services or who are responsible for compliance with this exemption or any other applicable rules; and (b) implementing policies and procedures for CME employees with access to such information with respect to trading for their own accounts. CME must adopt and implement adequate oversight procedures to ensure that the policies and procedures established pursuant to this condition are followed. This condition is designed to prevent any misuse of CME clearing member trading information that may be available to CME in connection with the daily settlement variation of open positions in Cleared CDS. This should strengthen confidence in CME as a CCP for CDS, thus promoting participation in central clearing of CDS.

Third, CME must comply with the conditions to the temporary exemption from Section 17A of the Exchange Act in this Order. This exemption from exchange registration is granted in the context of our goal of facilitating CME's ability to act as a CCP for non-excluded CDS. We note that CME has represented that given the requirement for CDS clearing members periodically to trade at prices generated by their indicative settlement prices where those indicative settlement prices generate crossed bids and offers, pursuant to CME's price quality auction methodology, its price auction methodology will be part of its CDS clearing process.

D. <u>Extended Temporary Conditional General Exemption for CME and Certain Eligible Contract Participants</u>

As we recognized when we initially provided temporary conditional exemptions in connection with CDS clearing by CME, applying the full panoply of Exchange Act requirements to participants in transactions in non-excluded CDS likely would deter some participants from using CCPs to clear CDS transactions. We also recognized that it is important that the antifraud provisions of the Exchange Act apply to transactions in non-excluded CDS, particularly given that OTC transactions subject to individual negotiation that qualify as security-based swap agreements already are subject to those provisions.[35]

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[35] While Section 3A of the Exchange Act excludes "swap agreements" from the definition of "security," certain antifraud and insider trading provisions under the Exchange Act explicitly apply to security-based swap agreements. <u>See</u> (a) paragraphs (2) through (5) of Section 9(a), 15 U.S.C. 78i(a),

As a result, we concluded that it is appropriate in the public interest and consistent with the protection of investors temporarily to apply substantially the same framework to transactions by market participants in non-excluded CDS that applies to transactions in security-based swap agreements. Consistent with that conclusion, we temporarily exempted CME and certain eligible contract participants from a number of Exchange Act requirements, while excluding certain enforcement-related and other provisions from the scope of the exemption.

We believe that continuing to facilitate the central clearing of CDS transactions by CME through this type of temporary conditional exemption will provide important risk management and systemic benefits. We also believe that facilitating the central clearing of customer CDS transactions, subject to the conditions in this Order, will provide an opportunity for the customers of CME clearing members to control counterparty risk.

Accordingly, pursuant to Section 36 of the Exchange Act, the Commission finds that it is necessary or appropriate in the public interest and is consistent with the protection of investors to grant an exemption until March 31, 2010, from the requirements of the Exchange Act discussed below, subject to certain conditions. This temporary exemption applies to CME and to eligible

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prohibiting the manipulation of security prices; (b) Section 10(b), 15 U.S.C. 78j(b), and underlying rules prohibiting fraud, manipulation or insider trading (but not prophylactic reporting or recordkeeping requirements); (c) Section 15(c)(1), 15 U.S.C. 78o(c)(1), which prohibits brokers and dealers from using manipulative or deceptive devices; (d) Sections 16(a) and (b), 15 U.S.C. 78p(a) and (b), which address disclosure by directors, officers and principal stockholders, and short-swing trading by those persons, and rules with respect to reporting requirements under Section 16(a); (e) Section 20(d), 15 U.S.C. 78t(d), providing for antifraud liability in connection with certain derivative transactions; and (f) Section 21A(a)(1), 15 U.S.C. 78u-1(a)(1), related to the Commission's authority to impose civil penalties for insider trading violations.

"Security-based swap agreement" is defined in Section 206B of the Gramm-Leach-Bliley Act as a swap agreement in which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.

contract participants[36] other than: eligible contract participants that receive or hold funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions for other persons;[37] eligible contract participants that are self-regulatory organizations; or eligible contract participants that are registered brokers or dealers.[38]

As before, under this temporary exemption, and solely with respect to Cleared CDS, those persons generally are exempt from the provisions of the Exchange Act and the rules and regulations thereunder that do not apply to security-based swap agreements. Thus, those persons will still be subject to those Exchange Act requirements that explicitly are applicable in connection with security-based swap agreements.[39] In addition, all provisions of the Exchange Act related to the Commission's enforcement authority in connection with violations or potential

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36 This exemption in general applies to eligible contract participants, as defined in Section 1a(12) of the CEA as in effect on the date of this Order, other than persons that are eligible contract participants under paragraph (C) of that section.

37 Solely for purposes of this requirement, an eligible contract participant would not be viewed as receiving or holding funds or securities for purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions for other persons, if the other persons involved in the transaction would not be considered "customers" of the eligible contract participant in a parallel manner when certain persons would not be considered "customers" of a broker-dealer under Exchange Act Rule 15c3-3(a)(1). For these purposes, and for the purpose of the definition of "Cleared CDS," the terms "purchasing" and "selling" mean the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing the rights or obligations under, a Cleared CDS, as the context may require. This is consistent with the meaning of the terms "purchase" or "sale" under the Exchange Act in the context of security-based swap agreements. See Exchange Act Section 3A(b)(4). A separate temporary conditional exemption addresses members of CME that hold funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions for other persons. See Part II.E, infra.

38 A separate temporary exemption addresses the Cleared CDS activities of registered-broker-dealers. See Part II.F, infra. Solely for purposes of this Order, a registered broker-dealer, or a broker or dealer registered under Section 15(b) of the Exchange Act, does not refer to someone that would otherwise be required to register as a broker or dealer solely as a result of activities in Cleared CDS in compliance with this Order.

39 See note 35, supra.

violations of such provisions remain applicable.[40] In this way, the temporary exemption applies the same Exchange Act requirements in connection with non-excluded CDS as apply in connection with OTC credit default swaps that are security-based swap agreements.

Consistent with our earlier exemptions, and for the same reasons, this temporary exemption also does not extend to: the exchange registration requirements of Exchange Act Sections 5 and 6;[41] the clearing agency registration requirements of Exchange Act Section 17A; the requirements of Exchange Act Sections 12, 13, 14, 15(d), and 16;[42] the Commission's administrative proceeding authority under Sections 15(b)(4) and (b)(6);[43] or certain provisions

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[40] Thus, for example, the Commission retains the ability to investigate potential violations and bring enforcement actions in the federal courts as well as in administrative proceedings, and to seek the full panoply of remedies available in such cases.

[41] These are subject to a separate temporary class exemption. See note 1, supra. A national securities exchange that effects transactions in Cleared CDS would continue to be required to comply with all requirements under the Exchange Act applicable to such transactions. A national securities exchange could form subsidiaries or affiliates that operate exchanges exempt under that order. Any subsidiary or affiliate of a registered exchange could not integrate, or otherwise link, the exempt CDS exchange with the registered exchange including the premises or property of such exchange for effecting or reporting a transaction without being considered a "facility of the exchange." See Section 3(a)(2), 15 U.S.C. 78c(a)(2).

This Order also includes a separate temporary exemption from Sections 5 and 6 in connection with the settlement price calculation methodology of CME, discussed above. See Part II.C, supra.

[42] 15 U.S.C. 78l, 78m, 78n, 78o(d), 78p. Eligible contract participants and other persons instead should refer to the interim final temporary rules issued by the Commission. See note 1, supra.

[43] Exchange Act Sections 15(b)(4) and 15(b)(6), 15 U.S.C. 78o(b)(4) and (b)(6), grant the Commission authority to take action against broker-dealers and associated persons in certain situations. Accordingly, while this exemption generally extends to persons that act as inter-dealer brokers in the market for Cleared CDS and do not hold funds or securities for others, such inter-dealer brokers may be subject to actions under Sections 15(b)(4) and (b)(6) of the Exchange Act. In addition, such inter-dealer brokers may be subject to actions under Exchange Act Section 15(c)(1), 15 U.S.C. 78o(c)(1), which prohibits brokers and dealers from using manipulative or deceptive devices. As noted above, Section 15(c)(1) explicitly applies to security-based swap agreements. Sections 15(b)(4), 15(b)(6), and 15(c)(1), of course, would not apply to persons subject to this exemption who do not act as broker-dealers or associated persons of broker-dealers.

related to government securities.[44] CME clearing members relying on this temporary exemption must be in material compliance with CME rules.

E. Conditional Temporary Exemption for Certain Clearing Members of CME

In the CME Exemptive Order, we granted a conditional temporary exemption from particular Exchange Act requirements to certain clearing members of CME that hold funds and securities of others in connection with Cleared CDS transactions. Absent an exception or exemption, persons that effect transactions in non-excluded CDS that are securities may be required to register as broker-dealers pursuant to Section 15(a)(1) of the Exchange Act.[45] Certain reporting and other requirements of the Exchange Act may also apply to such persons, as broker-dealers, regardless of whether they are registered with the Commission.

In granting that exemption, we noted that it is consistent with our investor protection mandate to require securities intermediaries that receive or hold funds and securities on behalf of others to comply with standards that safeguard the interests of their customers.[46] We also

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44 This exemption specifically does not extend to the Exchange Act provisions applicable to government securities, as set forth in Section 15C, 15 U.S.C. 78o-5, and its underlying rules and regulations; nor does the exemption extend to related definitions found at paragraphs (42) through (45) of Section 3(a), 15 U.S.C. 78c(a). The Commission does not have authority under Section 36 to issue exemptions in connection with those provisions. See Exchange Act Section 36(b), 15 U.S.C. 78mm(b).

45 15 U.S.C. 78o(a)(1). This section generally provides that, absent an exception or exemption, a broker or dealer that uses the mails or any means of interstate commerce to effect transactions in, or to induce or attempt to induce the purchase or sale of, any security must register with the Commission.

Section 3(a)(4) of the Exchange Act generally defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others," but provides 11 exceptions for certain bank securities activities. 15 U.S.C. 78c(a)(4). Section 3(a)(5) of the Exchange Act generally defines a "dealer" as "any person engaged in the business of buying and selling securities for his own account," but includes exceptions for certain bank activities. 15 U.S.C. 78c(a)(5). Exchange Act Section 3(a)(6) defines a "bank" as a bank or savings association that is directly supervised and examined by state or federal banking authorities (with certain additional requirements for banks and savings associations that are not chartered by a federal authority or a member of the Federal Reserve System). 15 U.S.C. 78c(a)(6).

46 Registered broker-dealers are required to segregate assets held on behalf of customers from proprietary assets, because segregation will assist customers in recovering assets in the event the

recognized, however, that requiring intermediaries that receive or hold funds and securities on behalf of customers in connection with transactions in non-excluded CDS to register as broker-dealers may deter the use of CCPs in CDS transactions, to the detriment of the markets and market participants generally. We concluded that those factors, along with certain representations by CME, argued in favor of flexibility in applying the requirements of the Exchange Act to these intermediaries. As a result, we provided a temporary conditional exemption to any CME clearing member registered as an FCM pursuant to Section 4f(a)(1) of the CEA (but not registered as a broker-dealer under Section 15(b) of the Exchange Act (other than paragraph (11) thereof)) that receives or holds funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions for other persons. Solely with respect to Cleared CDS, those members generally were exempted from provisions of the Exchange Act and the underlying rules and regulations that do not apply to security-based swap agreements.

When CME requested the exemptions that we granted in March, it stated that pending a receipt of an order from the CFTC pursuant to Section 4d of the CEA and related regulations, to permit CME and its members to establish segregated accounts for holding collateral posted by cleared CDS customers, FCMs would hold customer collateral within accounts established pursuant to CFTC Rule 30.7. Rule 30.7 provides a mechanism for establishing accounts for holding collateral posted by foreign futures customers.

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intermediary fails. Absent such segregation, collateral could be used by an intermediary to fund its own business, and could be attached to satisfy the intermediary's debts were it to fail. Moreover, the maintenance of adequate capital and liquidity protects customers, CCPs, and other market participants. Adequate books and records (including both transactional and position records) are necessary to facilitate day to day operations as well as to help resolve situations in which an intermediary fails and either a regulatory authority or receiver is forced to liquidate the firm. Appropriate records also are necessary to allow examiners to review for improper activities, such as insider trading or fraud.

We understand that the protections associated with using CFTC Rule 30.7 to segregate collateral associated with over-the-counter derivatives is untested,[47] and thus less certain than the protections that would be afforded to collateral protected by Section 4d. Also, we note that the CFTC has proposed a rule – not yet adopted – that would provide for the establishment of an account class, with respect to the bankruptcy of a commodity broker that is an FCM, that would be applicable to positions in cleared over-the-counter derivatives and collateral securing such positions.[48]

In light of the risk management and systemic benefits in continuing to facilitate CDS clearing by CME, while promoting customer protection in connection with those CDS transactions, the Commission finds pursuant to Section 36 of the Exchange Act that it is necessary or appropriate in the public interest and is consistent with the protection of investors to extend this temporary conditional exemption for certain CME clearing members from certain requirements of the Exchange Act in connection with Cleared CDS until March 31, 2010. As discussed below, this exemption has been modified in certain respects from the exemption that we previously granted to CME clearing members that receive or hold customer funds or securities in connection with Cleared CDS.

As before, this revised exemption will be available to any CME clearing member that is also an FCM (other than one that either is registered pursuant to Section 4f(a)(2) or is registered as a broker or dealer under Section 15(b) of the Exchange Act (other than paragraph (11) thereof)) that receives or holds funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions for other persons. Solely with respect to

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47 See text at note 23, supra.

48 See 74 FR 40794 (Aug. 13, 2009).

Cleared CDS, those members generally will be exempt from those provisions of the Exchange Act and the underlying rules and regulations that do not apply to security-based swap agreements. As with the exemption discussed above that is applicable to CME and certain eligible contract participants, and for the same reasons, this exemption for CME clearing members that receive or hold funds and securities does not extend to Exchange Act provisions that explicitly apply in connection with security-based swap agreements,[49] or to related enforcement authority provisions.[50] As with the exemption discussed above, we also are not exempting those members from Sections 5, 6, 12(a) and (g), 13, 14, 15(b)(4), 15(b)(6), 15(d), 16, and 17A of the Exchange Act.[51]

This temporary exemption is subject to the member complying with conditions that are important for protecting customer funds and securities. Any CME clearing member relying on this exemption must be in material compliance with the rules of CME (including Rules 971 and 973 relating to Segregation and Secured Requirements and Customer Accounts with the Clearing House). Such clearing members also must be in material compliance with applicable laws and regulations relating to capital, liquidity, and segregation of customers'[52] funds and securities (and related books and records provisions) with respect to Cleared CDS.[53]

Such CME clearing members must also comply with certain additional conditions – not in the earlier Order – with respect to such activities. The customers for whom the clearing

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49 See note 35, supra.

50 See note 40, supra.

51 See notes 41 through 43, supra, and accompanying text. Nor are we exempting those members from provisions related to government securities, as discussed above. See note 44, supra.

52 The term "customer," solely for purposes of Part III(d) and (e), infra, and corresponding references in this Order, means a "customer" as defined under CFTC Regulation 1.3(k). 17 CFR 1.3(k).

53 This condition is similar to a condition in the earlier Order.

member receives or holds such funds or securities may not be natural persons. In addition, the clearing member must make certain risk disclosures to those customers.[54]

This exemption is further conditioned on funds or securities received or held by the clearing member for the purpose of purchasing, selling, clearing, settling, or holding cleared CDS positions for those customers being held in one of three manners. First, such funds and securities may be held in an account established in accordance with Section 4d of the CEA and CFTC Rules 1.20 through 1.30 and 1.32 thereunder.

Alternatively, in the absence of a 4d order from the CFTC, those funds and securities may be held in an account that is part of a separate account class, specified by CFTC Bankruptcy Rules,[55] established for an FCM to hold its customers' positions in cleared OTC derivatives (and funds and securities posted to margin, guarantee, or secure such positions).

Finally, if neither of those other accounts is available, those funds and securities must be held in an account established in accordance with CFTC Rule 30.7.[56] In that situation, the clearing member must disclose to Cleared CDS customers that uncertainty exists as to whether they would receive priority in bankruptcy (vis-à-vis other customers) with respect to any funds or securities held by the clearing member to collateralize Cleared CDS positions.

To facilitate compliance with the segregation practices that are required as a condition to this temporary exemption, the clearing member – regardless of the type of account discussed

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[54] The clearing member must disclose that it is not regulated by the Commission, that U.S. broker-dealer segregation requirements and protections under the Securities Investor Protection Act will not apply to any funds or securities held by the clearing member to collateralize Cleared CDS, and that the applicable insolvency law may affect such customers' ability to recover funds and securities, or the speed of any such recovery, in an insolvency proceeding.

[55] 17 CFR 190.01 et seq.

[56] The conditions in this Order require that any FCM that holds Cleared CDS customer funds and securities in a 30.7 account must segregate all such customer funds and securities in a 30.7 account. It is our understanding that this is consistent with CME Rule 8F03.

above that it uses – also must annually provide CME with a self-assessment that it is in compliance with the requirements, along with a report by the clearing member's independent third-party auditor that attests to that assessment. The report must be dated the same date as the clearing member's annual audit report (but may be separate from it), and must be produced in accordance with the standards that the auditor follows in auditing the clearing member's financial statements.[57]

Finally, consistent with the CME Exemptive Order, a CME clearing member that receives or holds funds or securities of customers for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions shall segregate such funds and securities of customers from the CME clearing member's own assets (i.e., the member may not permit the customers to "opt out" of applicable segregation requirements for such funds and securities even if regulations or laws would permit the customer to "opt out").

F. Extended Temporary Conditional General Exemption for Certain Registered Broker-Dealers including Certain Broker-Dealer-FCMs

The CME Exemptive Order granted temporary limited exemptions from Exchange Act requirements to registered broker-dealers in connection with their activities involving Cleared CDS. In crafting these temporary exemptions, we balanced the need to avoid creating disincentives to the prompt use of CCPs against the critical role that certain broker-dealers play in promoting market integrity and protecting customers (including broker-dealer customers that are not involved with CDS transactions).

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57 This condition requiring the clearing member to convey a third-party audit report to CME as a repository for regulators does not impose upon CME any independent duty to audit or otherwise review that information. This condition also does not impose on CME any independent fiduciary or other obligation to any customer of a clearing member.

In light of the risk management and systemic benefits in continuing to facilitate CDS clearing by CME through targeted conditional exemptions to registered broker-dealers, the Commission finds pursuant to Section 36 of the Exchange Act that it is necessary or appropriate in the public interest and is consistent with the protection of investors to exercise its authority to extend this temporary conditional registered broker-dealer exemption from certain Exchange Act requirements until March 31, 2010.[58]

Consistent with the temporary exemptions discussed above, and solely with respect to Cleared CDS, we are temporarily exempting registered broker-dealers (including registered broker-dealers that are also FCMs ("BD-FCMs")) from provisions of the Exchange Act and the rules and regulations thereunder that do not apply to security-based swap agreements, subject to certain conditions. As discussed above, we are not excluding registered broker-dealers, including BD-FCMs, from Exchange Act provisions that explicitly apply in connection with security-based swap agreements or from related enforcement authority provisions.[59] As above, and for similar reasons, we are not exempting registered broker-dealers, including BD-FCMs,

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58 The temporary exemptions addressed above – with regard to CME, certain clearing members, and certain eligible contract participants – are not available to persons that are registered as broker-dealers with the Commission (other than those that are notice registered pursuant to Exchange Act Section 15(b)(11)). Exchange Act Section 15(b)(11) provides for notice registration of certain persons that effect transactions in security futures products. 15 U.S.C. 78o(b)(11).

59 See notes 35 and 40, supra. As noted above, broker-dealers also would be subject to Section 15(c)(1) of the Exchange Act, which prohibits brokers and dealers from using manipulative or deceptive devices, because that provision explicitly applies in connection with security-based swap agreements. In addition, to the extent the Exchange Act and any rule or regulation thereunder imposes any other requirement on a broker-dealer with respect to security-based swap agreements (e.g., requirements under Rule 17h-1T to maintain and preserve written policies, procedures, or systems concerning the broker or dealer's trading positions and risks, such as policies relating to restrictions or limitations on trading financial instruments or products), these requirements would continue to apply to broker-dealers' activities with respect to Cleared CDS.

from: Sections 5, 6, 12(a) and (g), 13, 14, 15(b)(4), 15(b)(6), 15(d), 16 and 17A of the Exchange Act.[60]

Further, we are not exempting registered broker-dealers from the following additional provisions under the Exchange Act: (1) Section 7(c),[61] regarding the unlawful extension of credit by broker-dealers; (2) Section 15(c)(3),[62] regarding the use of unlawful or manipulative devices by broker-dealers; (3) Section 17(a),[63] regarding broker-dealer obligations to make, keep, and furnish information; (4) Section 17(b),[64] regarding broker-dealer records subject to examination; (5) Regulation T,[65] a Federal Reserve Board regulation regarding extension of credit by broker-dealers; (6) Exchange Act Rule 15c3-1,[66] regarding broker-dealer net capital; (7) Exchange Act Rule 15c3-3,[67] regarding broker-dealer reserves and custody of securities; (8) Exchange Act Rules 17a-3 through 17a-5,[68] regarding records to be made and preserved by broker-dealers and reports to be made by broker-dealers; and (9) Exchange Act Rule 17a-13,[69] regarding quarterly security counts to be made by certain exchange members and broker-dealers.[70] Registered broker-dealers must comply with these provisions in connection with their

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60 See notes 41 through 43, supra, and accompanying text. We also are not exempting those members from provisions related to government securities, as discussed above. See note 44, supra.

61 15 U.S.C. 78g(c).

62 15 U.S.C. 78o(c)(3).

63 15 U.S.C. 78q(a).

64 15 U.S.C. 78q(b).

65 12 CFR 220.1 et seq.

66 17 CFR 240.15c3-1.

67 17 CFR 240.15c3-3.

68 17 CFR 240.17a-3 through 240.17a-5.

69 17 CFR 240.17a-13.

70 Solely for purposes of this temporary exemption, in addition to the general requirements under the referenced Exchange Act sections, registered broker-dealers shall only be subject to the enumerated rules under the referenced Exchange Act sections.

activities involving non-excluded CDS because these provisions are especially important to helping protect customer funds and securities, ensure proper credit practices, and safeguard against fraud and abuse.[71]

However, CME clearing members that are BD-FCMs and that receive or hold customer funds or securities for the purpose of purchasing, selling, clearing, settling, or holding CDS positions cleared by CME in a futures account (as that term is defined in Rule 15c3-3(a)(15)[72]) also shall be exempt from Exchange Act Rule 15c3-3, subject to conditions that are similar to those – discussed above – that are applicable to CME that are not broker-dealers and that hold customer funds and securities in connection with Cleared CDS transactions. Thus, such BD-FCMs must be in material compliance with CME rules, as well as and applicable laws and regulations relating to capital, liquidity, and segregation of customers' funds and securities (and related books and records provisions) with respect to Cleared CDS. A BD-FCM may not receive or hold funds or securities relating to Cleared CDS transactions and positions for customers who are natural persons. In addition, the BD-FCM must make certain risk disclosures to each such customer.[73] Further, the BD-FCM must hold the customer funds or securities in the same type of account (e.g., in a 4d account) as is required for other clearing members that hold customer funds

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71 Indeed, Congress directed the Commission to promulgate broker-dealer financial responsibility rules, including rules relating to custody, the use of customer securities, the use of customers' deposits or credit balances, and the establishment of minimum financial requirements. See Exchange Act Section 15(c)(3).

72 17 CFR 240.15c3-3(a)(15).

73 The BD-FCM must disclose that U.S. broker-dealer segregation requirements and protections under the Securities Investor Protection Act will not apply to any funds or securities held by the clearing member to collateralize Cleared CDS positions, and that the applicable insolvency law may affect such customers' ability to recover funds and securities, or the speed of any such recovery, in an insolvency proceeding.

This BD-FCM condition differs from the analogous disclosure condition related to other CME clearing members that hold customer funds and securities, in that the other condition also requires disclosure that the clearing member is not regulated by the Commission.

and securities in connection with Cleared CDS transactions.[74] The BD-FCM also must segregate the funds and securities of customers from the CME clearing member's own assets (i.e., the member may not permit the customers to "opt out" of applicable segregation requirements for such funds and securities even if regulations or laws would permit the customer to "opt out"). In addition, the BD-FCM also must annually provide CME with a self-assessment that it is in compliance with the requirements, along with a report by the clearing member's independent third-party auditor that attests to that assessment.[75]

Finally – and in addition to the conditions that are applicable to CME that are not broker-dealers and that hold customer funds and securities in connection with Cleared CDS transactions – the CME clearing member must comply with the margin rules for Cleared CDS of the self-regulatory organization that is its designated examining authority[76] (e.g., FINRA).

G. Solicitation of Comments

When we granted our initial temporary conditional exemptions in connection with CDS clearing by CME, we solicited comment on all aspects of the exemptions, and specifically

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[74] As with the exemption applicable to those other CME clearing members, in the absence of a 4d order from the CFTC, the BD-FCM may hold the funds and securities in an account that is part of a separate account class, specified by CFTC Bankruptcy Rules, established for an FCM to hold its customers' positions in cleared OTC derivatives (and funds and securities posted to margin, guarantee, or secure such positions). See Part II.E, supra.

If that alternative also is not available, the BD-FCM must hold the funds and securities in an account established in accordance with CFTC Rule 30.7. In that situation, the clearing member must disclose to Cleared CDS customers that uncertainty exists as to whether they would receive priority in bankruptcy (vis-à-vis other customers) with respect to any funds or securities held by the clearing member to collateralize Cleared CDS positions.

As above, the conditions in this Order require that BD-FCM (as well as any other FCM) that holds Cleared CDS customer funds and securities in a 30.7 account must segregate all such customer funds and securities in a 30.7 account.

[75] The report must be dated the same date as the clearing member's annual audit report (but may be separate from it), and must be produced in accordance with the standards that the auditor follows in auditing the clearing member's financial statements. See text accompanying note 57, supra.

[76] See 17 CFR 240.17d-1 for a description of a designated examining authority.

requested comment as to the duration of the temporary exemptions, the appropriateness of the exemptive conditions, and whether CME should be required to register as a clearing agency under the Exchange Act. We received no comments in response to this request.

In connection with this Order extending the temporary conditional exemptions granted in connection with CDS clearing by CME, and expanding that relief to accommodate CME's settlement price calculation methodology, we reiterate our request for comments on all aspects of the exemptions. We particularly request comments as to the exemption we are granting in connection with the calculation of settlement prices, including whether the conditions on the exemption promote fair and accurate settlement prices and include adequate safeguards and procedures to protect clearing members' confidential trading information. We also request comment on the adequacy of the proposed conditions for the protection of customer assets, including whether it is appropriate to permit such assets to be protected in an account that is subject to the framework provided by CFTC Rule 30.7, and, if so, whether the conditions associated with the use of that account are adequate. In addition, we request comment on whether additional conditions or requirements are appropriate to promote compliance with the requirements of the temporary conditional exemptions, and what, if any, additional conditions would be appropriate.

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-06-09 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 S7-06-09. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. We will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/other.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

III. Conclusion

IT IS HEREBY ORDERED, pursuant to Section 36(a) of the Exchange Act, that, until March 31, 2010:

(a) Exemption from Section 17A of the Exchange Act.

The Chicago Mercantile Exchange Inc. ("CME") shall be exempt from Section 17A of the Exchange Act solely to perform the functions of a clearing agency for Cleared CDS (as defined in paragraph (f) of this Order), subject to the following conditions:

(1) CME shall make available on its Web site its annual audited financial statements.

(2) CME shall keep and preserve records of all activities related to the business of CME as a central counterparty for Cleared CDS. These records shall be kept for at least five years and for the first two years shall be held in an easily accessible place.

(3) CME shall supply such information and periodic reports relating to its Cleared CDS clearance and settlement services as may be reasonably requested by the Commission. CME shall also provide access to the Commission to conduct on-site inspections of all facilities (including automated systems and systems environment), and records related to its Cleared CDS clearance and settlement services. CME will provide the Commission with access to its personnel to answer reasonable questions during any such inspections related to its Cleared CDS clearance and settlement services.

(4) CME shall notify the Commission, on a monthly basis, of any material disciplinary actions taken against any CME clearing members utilizing its Cleared CDS clearance and settlement services, including the denial of services, fines, or penalties. CME shall notify the Commission promptly when CME involuntarily terminates the membership of an entity that is utilizing CME's Cleared CDS clearance and settlement services. Both notifications shall describe the facts and circumstances that led to CME's disciplinary action.

(5) CME shall notify the Commission of all changes to rules as defined under the CFTC rules, fees, and any other material events affecting its Cleared CDS clearance and settlement services, including material changes to risk management models. In addition, CME will post any rule or fee changes on the CME Web site. CME shall provide the Commission with notice of all changes to its rules not less than one day prior to effectiveness or implementation of such rule changes or, in exigent circumstances, as

promptly as reasonably practicable under the circumstances. Such notifications will not be deemed rule filings that require Commission approval.

(6) CME shall provide the Commission with annual reports and any associated field work concerning its Cleared CDS clearance and settlement services prepared by independent audit personnel that are generated in accordance with risk assessment of the areas set forth in the Commission's Automation Review Policy Statements. CME shall provide the Commission (beginning in its first year of operation) with its annual audited financial statements prepared by independent audit personnel for CME.

(7) CME shall report to the Commission all significant outages of clearing systems having a material impact on its Cleared CDS clearance and settlement services. If it appears that the outage may extend for 30 minutes or longer, CME shall report the systems outage immediately. If it appears that the outage will be resolved in less than 30 minutes, CME shall report the systems outage within a reasonable time after the outage has been resolved.

(8) CME, directly or indirectly, shall make available to the public on terms that are fair and reasonable and not unreasonably discriminatory: (i) all end-of-day settlement prices and any other prices with respect to Cleared CDS that CME may establish to calculate settlement variation or margin requirements for CME clearing members; and (ii) any other pricing or valuation information with respect to Cleared CDS as is published or distributed by CME.

(9) CME shall not materially change its methodology for determining Cleared CDS margin levels without prior written approval from the Commission, and from FINRA with respect to customer margin requirements that would apply to broker-dealers.

(b) Exemption from Sections 5 and 6 of the Exchange Act

(1) CME shall be exempt from the requirements of Sections 5 and 6 of the Exchange Act and the rules and regulations thereunder in connection with its calculation of settlement prices for Cleared CDS, subject to the following conditions:

(i) CME shall report the following information with respect to its determination of daily settlement prices for Cleared CDS to the Commission within 30 days of the end of each quarter, and preserve such reports for as long as CME offers CDS clearing services and for a period of at least five years thereafter:

(A) the total dollar volume of CDS transactions executed during the quarter pursuant to CME's price quality auction methodology, broken down by reference entity, security, or index; and

(B) the total unit volume or notional amount executed during the quarter pursuant to CME's price quality auction methodology, broken down by reference entity, security, or index;

(ii) CME shall establish and maintain adequate safeguards and procedures to protect participants' confidential trading information related to Cleared CDS. Such safeguards and procedures shall include:

(A) limiting access to the confidential trading information of participants to those CME employees who have a need to access such information in connection with the provision of CME CDS clearing services or who are responsible for compliance with this exemption or any other applicable rules; and

(B) implementing policies and procedures for CME employees with access to such information with respect to trading for their own accounts. CME shall adopt and implement adequate oversight procedures to ensure that the policies and procedures established pursuant to this condition are followed; and

(iii) CME shall satisfy the conditions of the temporary exemption from Section 17A of the Exchange Act set forth in paragraphs (a)(1) – (9) of this Order.

(2) Any CME clearing member shall be exempt from the requirements of Section 5 of the Exchange Act to the extent such CME clearing member uses any facility of CME to effect any transaction in Cleared CDS, or to report any such transaction, in connection with CME's clearance and risk management process for Cleared CDS.

(c) Exemption for CME and certain eligible contract participants.

(1) Persons eligible. The exemption in paragraph (c)(2) is available to:

(i) CME; and

(ii) Any eligible contract participant (as defined in Section 1a(12) of the Commodity Exchange Act as in effect on the date of this Order (other than a person that is an eligible contract participant under paragraph (C) of that section)), other than:

(A) an eligible contract participant that receives or holds funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions for other persons;

(B) an eligible contract participant that is a self-regulatory organization, as that term is defined in Section 3(a)(26) of the Exchange Act; or

(C) a broker or dealer registered under Section 15(b) of the Exchange Act (other than paragraph (11) thereof).

(2) Scope of exemption.

(i) In general. Subject to the condition specified in paragraph (c)(3), such persons generally shall, solely with respect to Cleared CDS, be exempt from the provisions of the Exchange Act and the rules and regulations thereunder that do not apply in connection with security-based swap agreements. Accordingly, under this exemption, those persons would remain subject to those Exchange Act requirements that explicitly are applicable in connection with security-based swap agreements (i.e., paragraphs (2) through (5) of Section 9(a), Section 10(b), Section 15(c)(1), subsections (a) and (b) of Section 16, Section 20(d), and Section 21A(a)(1), and the rules thereunder that explicitly are applicable to security-based swap agreements). All provisions of the Exchange Act related to the Commission's enforcement authority in connection with violations or potential violations of such provisions also remain applicable.

(ii) Exclusions from exemption. The exemption in paragraph (c)(2)(i), however, does not extend to the following provisions under the Exchange Act:

(A) Paragraphs (42), (43), (44), and (45) of Section 3(a);

(B) Section 5;

(C) Section 6;

(D) Section 12 and the rules and regulations thereunder;

(E) Section 13 and the rules and regulations thereunder;

(F) Section 14 and the rules and regulations thereunder;

(G) Paragraphs (4) and (6) of Section 15(b);

(H) Section 15(d) and the rules and regulations thereunder;

(I) Section 15C and the rules and regulations thereunder;

(J) Section 16 and the rules and regulations thereunder; and

(K) Section 17A (other than as provided in paragraph (a)).

(3) Condition for CME clearing members. Any CME clearing member relying on this exemption must be in material compliance with the rules of CME.

(d) Exemption for certain CME clearing members.

Any CME clearing member registered as a futures commission merchant pursuant to Section 4f(a)(1) of the Commodity Exchange Act (but that is not registered as a broker or dealer under Section 15(b) of the Exchange Act (other than paragraph (11) thereof)) that receives or holds funds or securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS for other persons shall be exempt from the provisions of the Exchange Act and the rules and regulations thereunder specified in paragraph (c)(2), solely with respect to Cleared CDS, subject to the following conditions:

(1) The clearing member shall be in material compliance with the rules of CME (including Rules 971 and 973 relating to Segregation and Secured Requirements and Customer Accounts with the Clearing House), and also shall be in material compliance with applicable laws and regulations, relating to capital, liquidity, and segregation of

customers' funds and securities (and related books and records provisions) with respect to Cleared CDS;

(2) The customers for whom the clearing member receives or holds such funds or securities shall not be natural persons;

(3) The clearing member shall disclose to such customers that the clearing member is not regulated by the Commission, that U.S. broker-dealer segregation requirements and protections under the Securities Investor Protection Act will not apply to any funds or securities held by the clearing member to collateralize Cleared CDS positions, and that the applicable insolvency law may affect such customers' ability to recover funds and securities, or the speed of any such recovery, in an insolvency proceeding;

(4) Customer funds and securities received or held by the clearing member for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions for such customers shall be held in one of the following manners:

(i) In an account established in accordance with section 4d of the Commodity Exchange Act and CFTC Rules 1.20 through 1.30 and 1.32 [17 CFR 1.20 through 1.30 and 1.32] thereunder;

(ii) In the absence of an Order from the Commodity Futures Trading Commission ("CFTC") permitting the use of an account specified in subparagraph (d)(4)(i) for holding such funds and securities, in an account that is part of a separate account class, specified by CFTC Bankruptcy Rules [17 CFR 190.01 et seq.], established for a futures commission merchant to hold its customers' positions in cleared OTC derivatives (and funds and securities posted to margin, guarantee, or secure such positions); or

(iii) If the clearing member is unable to hold such funds and securities as specified in subparagraph (d)(4)(i) or (ii), the clearing member shall:

(A) hold such funds and securities in a separate account that is established in accordance with CFTC Rule 30.7 [17 CFR 30.7], and

(B) disclose to such customers that uncertainty exists as to whether they would receive priority in bankruptcy (vis-á-vis other customers) with respect to any funds or securities held by the clearing member to collateralize Cleared CDS positions.

(5) The clearing member annually shall provide CME with

(i) an assessment by the clearing member that it is in compliance with all the provisions of subparagraphs (d)(4)(i) through (iii) in connection with such activities, and

(ii) a report by the clearing member's independent third-party auditor that attests to, and reports on, the clearing member's assessment described in subparagraph (d)(5)(i) and that is:

(A) dated as of the same date as, but which may be separate and distinct from, the clearing member's annual audit report;

(B) produced in accordance with the auditing standards followed by the independent third-party auditor in its audit of the clearing member's financial statements.

(6) To the extent that the clearing member receives or holds funds or securities of customers for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS positions, the clearing member shall segregate such funds and securities of customers from the clearing member's own assets (i.e., the member may not permit such customers to "opt out" of applicable segregation requirements for such funds and securities even if regulations or laws would permit the customer to "opt out").

(e) Exemption for certain registered broker-dealers.

(1) In general. A broker or dealer registered under Section 15(b) of the Exchange Act (other than paragraph (11) thereof) shall be exempt from the provisions of the Exchange Act and the rules and regulations thereunder specified in paragraph (c)(2), solely with respect to Cleared CDS, except:

(i) Section 7(c);

(ii) Section 15(c)(3);

(iii) Section 17(a);

(iv) Section 17(b);

(v) Regulation T, 12 CFR 200.1 et seq.;

(vi) Rule 15c3-1;

(vii) Rule 15c3-3;

(viii) Rule 17a-3;

(ix) Rule 17a-4;

(x) Rule 17a-5; and

(xi) Rule 17a-13.

(2) Broker-dealers that also are futures commission merchants. A CME clearing member that is a broker or dealer registered under Section 15(b) of the Exchange Act (other than paragraph (11) thereof) and that is also registered as a futures commission merchant pursuant to Section 4f(a)(1) of the Commodity Exchange Act and that receives or holds customer funds and securities for the purpose of purchasing, selling, clearing, settling, or holding Cleared CDS in a futures account (as that term is defined in Rule 15c3-3(a)(15) [17 CFR 240.15c3-3(a)(15)]) also shall be exempt from Exchange Act Rule 15c3-3, subject to the following conditions:

(i) the clearing member shall comply with the conditions set forth in paragraphs (d)(1), (2), (4), (5), and (6) above;

(ii) the clearing member shall disclose to Cleared CDS customers that the U.S. broker-dealer segregation requirements and protections under the Securities Investor Protection Act will not apply to funds or securities held by the clearing member to collateralize Cleared CDS positions, and that the applicable insolvency law may affect such customers' ability to recover funds and securities, or the speed of any such recovery, in an insolvency proceeding; and

(iii) The CME clearing member shall collect from each customer the amount of margin that is not less than the amount required for Cleared CDS under the margin rule of the self-regulatory organization that is its designated examining authority.

(f) For purposes of this Order, "Cleared CDS" shall mean a credit default swap that is submitted (or offered, purchased, or sold on terms providing for submission) to CME, that is offered only to, purchased only by, and sold only to eligible contract participants (as defined in

Section 1a(12) of the Commodity Exchange Act as in effect on the date of this Order (other than a person that is an eligible contract participant under paragraph (C) of that section)), and in which:

(1) the reference entity, the issuer of the reference security, or the reference security is one of the following:

(i) an entity reporting under the Exchange Act, providing Securities Act Rule 144A(d)(4) information, or about which financial information is otherwise publicly available;

(ii) a foreign private issuer whose securities are listed outside the United States and that has its principal trading market outside the United States;

(iii) a foreign sovereign debt security;

(iv) an asset-backed security, as defined in Regulation AB, issued in a registered transaction with publicly available distribution reports; or

(v) an asset-backed security issued or guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae; or

(2) the reference index is an index in which 80 percent or more of the index's weighting is comprised of the entities or securities described in subparagraph (1).

By the Commission.

Florence E. Harmon

Florence E. Harmon
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES ACT OF 1933
Rel. No. 9088 / December 15, 2009

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 61167 / December 15, 2009

Admin. Proc. File No. 3-12559

In the Matter of

GREGORY O. TRAUTMAN

c/o Leon Baer Borstein
Borstein & Sheinbaum
420 Lexington Avenue, Suite 2920
New York, New York 10170

OPINION OF THE COMMISSION

BROKER-DEALER PROCEEDING

CEASE-AND-DESIST PROCEEDING

Grounds for Remedial Action

Antifraud violations

Aiding and abetting antifraud violations

Respondent, who was co-founder, president, and chief executive officer of registered broker-dealer, willfully violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Exchange Act Rule 10b-5 by engaging in a scheme to defraud mutual funds and their shareholders through unlawful late trading and deceptive market timing in mutual fund shares on behalf of customers and for broker-dealer's own account. In addition, Respondent willfully aided and abetted, and was a cause of, broker-dealer's violations of Exchange Act Section 15(c) and Exchange Act Rule 10b-3. *Held*, it is in the public interest to bar Respondent from associating with any broker or dealer; to impose a cease-and-desist order; to require disgorgement of $608,886, plus prejudgment interest; and to assess a $120,000 third-tier civil penalty.

APPEARANCES:

Leon Baer Borstein, of Borstein & Sheinbaum, for Gregory O. Trautman.

Alexander M. Vasilescu, *Paul G. Gizzi*, *Robert H. Murphy*, and *Bennett Ellenbogen*, for the Division of Enforcement.

Appeal filed: February 26, 2008
Last brief filed: May 22, 2008
Oral Argument held: July 21, 2009

I.

Gregory O. Trautman ("Trautman"), co-founder, president, and chief executive officer of Trautman Wasserman & Company, Inc. ("TWCO"),[1] a registered broker-dealer, appeals from an administrative law judge's initial decision. The law judge found that, between January 2001 and September 2003, Trautman engaged in a scheme to defraud mutual funds and mutual fund shareholders through late trading and deceptive market timing of mutual fund shares on behalf of TWCO's customers and for TWCO's own account.[2] The law judge concluded that Trautman willfully violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities

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[1] TWCO was named as a respondent in the Order Instituting Proceedings ("OIP") but defaulted by failing to file an answer or otherwise defend the proceeding. *See Trautman Wasserman & Co.*, Initial Decision Rel. No. 340 (Jan. 14, 2008), 92 SEC Docket 1451, 1468. The law judge revoked TWCO's broker-dealer registration, required TWCO to disgorge the amount of its assets not exceeding $9,040,000, plus prejudgment interest, and ordered TWCO to pay a $500,000 civil penalty. We declared that decision final. *Trautman Wasserman & Co.*, Securities Exchange Act Rel. No. 57493 (Mar. 13, 2008), 92 SEC Docket 3317.

[2] In addition to Trautman and TWCO, the OIP named as respondents TWCO's chairman and co-founder Samuel M. Wasserman, TWCO's chief financial officer ("CFO") Mark Barbera, TWCO registered representative James A. Wilson, Jr., TWCO's chief administrative officer Jerome Snyder, and TWCO's chief compliance officer Forde H. Prigot. By the end of the hearing, all of these individual respondents, except for Wasserman, had settled the allegations against them. *See Trautman Wasserman & Co.*, Exchange Act Rel. Nos. 57327, 57328, & 57329 (Feb. 14, 2008), 92 SEC Docket 2241 (Barbera), 2249 (Wilson) & 2422 (Prigot); *Trautman Wasserman & Co.*, Exchange Act Rel. No. 55990 (June 29, 2007), 90 SEC Docket 3109 (Snyder). Following the hearing, the law judge imposed a supervisory bar against Wasserman and ordered him to disgorge $25,000, plus prejudgment interest, for his willful violations of Securities Act Sections 17(a)(2) and 17(a)(3). *See Trautman Wasserman & Co.*, 92 SEC Docket at 1483. We also declared that decision final. *Trautman Wasserman & Co.*, 92 SEC Docket at 3317.

Exchange Act of 1934, and Exchange Act Rule 10b-5.[3] The law judge also concluded that Trautman willfully aided and abetted, and was a cause of, TWCO's violations of Exchange Act Section 15(c) and Exchange Act Rule 10b-3[4] and TWCO's clearing firm's violations of Rule 22c-1 of the Investment Company Act of 1940.[5] The law judge barred Trautman from associating with any broker or dealer; prohibited him from serving or acting in various capacities with respect to a registered investment company; imposed a cease-and-desist order against him; ordered disgorgement of $1,373,799.75, plus prejudgment interest; and assessed a $500,000 third-tier civil penalty. We base our findings on an independent review of the record, except as to those findings not challenged on appeal.

II.

A. Late Trading and Market Timing of Mutual Funds

Mutual fund shares can be bought and sold all day. The price of a mutual fund share is based on its net asset value ("NAV"). NAV is the current market value of a mutual fund's total assets, minus its total liabilities, divided by the total number of shares outstanding. Mutual funds generally calculate NAV once a day,[6] usually when the major United States stock exchanges close at 4:00 p.m. Eastern time.[7] Mutual funds typically disclose in their prospectuses the time

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[3] 15 U.S.C. §§ 77q(a), 78j(b) & 17 C.F.R. § 240.10b-5 (prohibiting fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities).

[4] 15 U.S.C. § 78o(c) & 17 C.F.R. § 240.10b-3 (prohibiting fraudulent conduct by brokers or dealers in connection with the purchase or sale of securities).

[5] 17 C.F.R. § 270.22c-1(a) (prohibiting dealers in a mutual fund's shares, among others, from effecting a trade at a day's price if the trade was received after the time when the mutual fund had calculated that day's price). Trautman was not charged with directly violating Rule 22c-1 because he is not within the class of persons or entities subject to its provisions. *See id.* We have determined not to address Trautman's secondary liability for TWCO's clearing firm's violations of Rule 22c-1. *See infra* n. 75.

[6] *See* 17 C.F.R. § 270.22c-1(b)(1) (generally requiring mutual funds to calculate their NAVs at least once daily, Monday through Friday, but providing for certain exceptions).

[7] *See, e.g.*, *DH2, Inc. v. SEC*, 422 F.3d 591, 592 (7th Cir. 2005) (stating that a mutual fund's NAV is "generally fixed by a fund when the major U.S. stock markets close at 4:00 p.m. [E]astern time"); *SEC v. Simpson Capital Mgmt., Inc.*, 586 F. Supp. 2d 196, 199 (S.D.N.Y. 2008) (stating that "[t]he prices of mutual fund shares are not continually reset over the course of the day, but are typically fixed for an entire day at a single price. Mutual funds . . . generally

(continued...)

when NAV is computed. The prospectuses of mutual funds traded by TWCO and its customers disclosed that the funds calculated NAV "at" the close of regular trading on the New York Stock Exchange ("NYSE"), normally 4:00 p.m. Many of the prospectuses stated that the funds had to receive orders by 4:00 p.m. in order to be executed at that day's NAV. Some of the prospectuses further stated that the time of receipt of an order by a mutual fund intermediary, rather than by the mutual fund itself, was the time for determining the price that the order would receive.[8] It therefore follows that an investor who places a mutual fund order before 4:00 p.m. will receive that day's NAV, while an investor who places an order after 4:00 p.m. will receive the next day's NAV.

"Late trading" refers to the unlawful practice of permitting mutual fund orders received after the 4:00 p.m. pricing time to receive the NAV calculated as of 4:00 p.m. the same day, instead of 4:00 p.m. the following day.[9] Late trading enables the trader to profit from market

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7 (...continued) determine the NAV of mutual fund shares at the close of the major United States securities exchanges and markets – 4:00 p.m. ET [Eastern Time]."); *Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings*, Investment Company Act Rel. No. 26287 (Dec. 11, 2003), 81 SEC Docket 2971, 2976 (proposed rule) (stating that, "[t]ypically, mutual funds calculate their NAVs once each day at or near the close of the major U.S. securities exchanges and markets (usually 4:00 p.m., Eastern time)"). All times referenced in this opinion are Eastern time.

8 *See Amendments to Rules Governing Pricing of Mutual Fund Shares*, Investment Co. Act Rel. No. 26288 (Dec. 11, 2003), 81 SEC Docket 3177, 3179 (stating that under Investment Company Act Rule 22c-1 mutual fund orders must be submitted to dealers and other intermediaries by 4:00 p.m. in order to receive the current day's share price); *Staff Interpretive Positions Relating to Rule 22c-1*, Investment Co. Act Rel. No. 5569 (Jan. 9, 1969), 1969 WL 96373 (stating that Investment Company Act Rule 22c-1 "contemplates that the time of receipt of the order by the retail dealer is controlling" for determining the price that the order receives).

9 *See, e.g., SEC v. Pentagon Capital Mgmt. PLC*, 612 F. Supp. 2d 241, 248 (S.D.N.Y. 2009) (stating that late trading "refers to the practice of placing orders to buy, redeem or exchange U.S. mutual fund shares after the time as of which the funds calculate their NAV, but receiving the price based on the prior day's NAV"); *In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d 845, 852 n.1 (D. Md. 2005) (stating that late trading is "the practice of placing orders to buy or sell mutual fund shares after 4:00 p.m. ET [Eastern Time], but receiving the price based on the prior NAV already determined as of 4:00 p.m. that same day") & *id.* at 856 (holding that "[l]ate trading is itself illegal, and therefore, as alleged by plaintiffs, a scheme, practice, or course of business effectuating late trading is inherently fraudulent"); *Scott G. Monson*, Investment Co. Act Rel. No. 28323 (June 30, 2008), 93 SEC Docket 7517, 7518 n.2 (stating that "[t]he illegal practice of permitting a purchase or redemption order received after the fund calculates its NAV (continued...)

events, such as earnings announcements and futures trading, that occur after 4:00 p.m. but are not reflected in the current day's NAV. The late trader obtains an advantage, at the expense of other shareholders of the mutual fund, when he learns of market moving information and is able to buy or sell mutual fund shares at NAVs set before the market moving information is released. Late trading violates the "forward pricing rule" set forth in Investment Company Act Rule 22c-1,[10] which requires the price of mutual fund shares to be set at the NAV "next computed" by the fund

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[9] (...continued)
(typically 4:00 p.m. Eastern Time) to receive the same day's NAV is referred to as 'late trading'"); *Charles C. Fawcett*, Exchange Act Rel. No. 56770 (Nov. 8, 2007), 91 SEC Docket 3147, 3148 n.4 (stating that "[l]ate trading is the illegal practice of permitting a purchase or redemption order received after the 4:00 p.m. pricing time to receive the share price calculated as of 4:00 p.m. that day") (internal quotations and citation omitted).

[10] Decisions interpreting Rule 22c-1 have read it to prohibit mutual fund investors from trading a fund's shares after the 4:00 p.m. pricing time while still receiving that day's NAV. *See Simpson Capital Mgmt.*, 586 F. Supp. 2d at 202 (holding that Rule 22c-1's requirement that the price of mutual fund shares be set at the NAV "next computed" by a mutual fund after the receipt of an order to buy or sell shares established that the time for setting NAV is the time "as of" which the NAV is calculated, generally 4:00 p.m., and not, as defendants argued, the time when the calculation is actually made) & *id.* at 203 (stating that defendants' interpretation of the Rule "would allow dealers to provide their customers with the same day's NAV on mutual fund trades submitted until the actual point of NAV calculation and would allow an end run around Congress's and the Commission's intent to prevent dilution of share value, speculative trading, and unfair treatment of investors"); *SEC v. JB Oxford Holdings, Inc.*, No. CV-04-7084 PA (C.D. Cal. Aug. 24, 2005) (unpublished minute order) (giving deference to Commission's interpretation of Rule 22c-1 setting the relevant "as of" time as the time that a mutual fund values its holdings for purposes of pricing mutual fund trades, rather than the time a fund actually performs its NAV calculation); *Paul A. Flynn*, Initial Decision No. 316 (Aug. 2, 2006), 88 SEC Docket 2146, 2173-74 (ALJ decision) (holding that the phrase "NAV that is next computed" means the NAV as of the time the mutual fund sets for its calculation, which is typically 4:00 p.m.), *declared final*, Exchange Act Rel. No. 54390 (Aug. 31, 2006), 88 SEC Docket 2649; *see also, e.g., Prusky v. Reliastar Life Ins. Co.*, 445 F.3d 695, 698 n.5 (3d Cir. 2006) (stating that "[t]he term 'late trading' is somewhat misleading because trading after the close of the market is entirely permissible so long as the trades are priced using the NAV set the next day. The Rule [Rule 22c-1]'s requirement that prices be based on the next computed NAV is referred to as 'forward pricing.' Thus, late trading may be more aptly described as violating the forward pricing rule.") (citations omitted); *Amendments to Rules Governing Pricing of Mutual Fund Shares*, 81 SEC Docket at 3178 (stating that "[l]ate trading not only violates [R]ule 22c-1, but managers who permit late trading also breach their fiduciary duties to the funds and fund shareholders").

after the receipt of an order to buy or sell shares.[11] Late trading harms innocent mutual fund shareholders by diluting the value of their investment.[12]

"Market timing" includes the frequent buying and selling of shares of the same mutual fund in order to exploit inefficiencies in mutual fund pricing.[13] Market timing, while not itself illegal, can harm mutual fund shareholders by, among other things, diluting the value of their shares (if the market timer is exploiting pricing inefficiencies), disrupting the management of the mutual fund's investment portfolio, and causing the targeted mutual fund to incur costs borne by

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[11] Investment Company Act Rule 22c-1's primary purpose is to prevent dilution-based abuses related to "backward pricing," the practice of basing the price of a mutual fund share on the NAV determined as of the close of the markets on the previous day. *See, e.g., Adoption of Rule 22c-1 under the Investment Company Act of 1940 Prescribing the Time of Pricing Redeemable Securities for Distribution, Redemption, and Repurchase and Amendment of Rule 17a-3(a)(7) under the Securities Exchange Act of 1934 Requiring Dealers to Time-Stamp Orders*, Investment Co. Act Rel. No. 5519 (Oct. 16, 1968), 1968 WL 87057; *see also, e.g., United States v. NASD*, 422 U.S. 694, 707 (1975) (explaining that the "interim period" between the calculation of a mutual fund's closing price on the previous day and the next-day opening price based on the NAV at the current day's closing provides opportunities to engage in "riskless trading" by exploiting the price difference).

[12] *Pentagon Capital Mgmt.*, 612 F. Supp. 2d at 248; *see In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d at 852 n.1 (discussing plaintiff's allegations of adverse affects of late trading and market timing).

[13] *Pentagon Capital Mgmt.*, 612 F. Supp. 2d at 253; *see, e.g., SEC v. Ficken*, 546 F.3d 45, 48 (1st Cir. 2008) (stating that "[m]arket timing is a mutual fund share trading strategy that exploits brief discrepancies between the stock prices used to calculate the shares' value once a day, and the prices at which those stocks are actually trading") (internal quotations and citation omitted); *In re Mut. Funds Inv. Litig.*, 529 F.3d 207, 210-11 (4th Cir. 2008) (describing market timing as a form of arbitrage in which "investors move in and out of the funds to take advantage of the temporary differentials between the mutual funds' daily calculated 'net asset value' ('NAV') and the market price of the component stocks during the course of a day"); *In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d at 852 n.1 (observing that "[m]arket timing is the frequent buying and selling of mutual fund shares to exploit any lag between changes in the value of the fund's portfolio of securities and the reflection of that change in a mutual fund's share price"); *SEC v. Pimco Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d 454, 458 (S.D.N.Y. 2004) (stating that "[m]utual fund market timing is a form of arbitrage activity that takes advantage of small short-term fluctuations in mutual fund prices"), *reconsideration denied sub nom. SEC v. Treadway*, 354 F. Supp. 2d 311 (S.D.N.Y. 2005).

other fund shareholders to accommodate the market timer's frequent buying and selling of shares.[14]

During the relevant period, mutual funds sought to detect and prevent harmful market timing activity. Representatives from several mutual funds testified at the hearing about their respective funds' anti-market timing policies, which generally were disclosed in the funds' prospectuses. Those policies included restrictions on frequent trading in the funds. Traders identified by the mutual funds as market timers typically received letters warning them that they could not use the funds to engage in market timing, had their accounts blocked or frozen, and in some cases were banned from subsequent trading in the funds.

B. Trautman and TWCO

Trautman began his career in the securities industry in 1988. Over the ensuing years, he obtained several securities licenses, including supervisory licenses.[15] Trautman was associated with five other broker-dealers before co-founding TWCO, a small registered broker-dealer headquartered in New York, New York, in 1993. Trautman was TWCO's president and chief executive officer and owned approximately thirty-eight percent of the firm. Before 2001, TWCO's primary business was raising venture capital from accredited investors for investment in private equity companies. The firm also had a retail brokerage business.

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[14] *See, e.g., Ficken*, 546 F.3d at 48 (stating that, "[a]lthough market timing is not illegal, mutual fund companies often prohibit market timing in order to protect long-term shareholders from dilution or other adverse effects caused by rapid and repeated short-term mutual fund transactions"); *In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d at 856 (stating that "[m]arket timing . . . is not illegal per se," but that "it nevertheless is prohibited by [Exchange Act] Rule 10b-5 if it is engaged in by favored market insiders at the expense of long-term mutual fund investors from whom it is concealed and who have a right to rely upon its prevention by fund advisers' and managers' good faith performance of their fiduciary obligations"); *Pimco Advisors Fund Mgmt.*, 341 F. Supp. 2d at 458 (stating that, "[w]hile market timing can be a successful strategy for individual investors and is not itself illegal, it can also harm investors in a mutual fund that permits market timing by increasing trading and brokerage costs, as well as tax liabilities incurred by a fund and spread across all investors. The quick pace of investments and redemptions associated with market timing may also hinder the ability of mutual fund managers to act in the best interests of fund investors who seek to maximize their long-term investment gains."). For a fuller discussion of mutual fund market timing and the problems it can cause, *see generally Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings*, Securities Act Rel. No. 8343 (Dec. 11, 2003), 81 SEC Docket 2971.

[15] NASD (now FINRA) revoked Trautman's NASD registration in June 2007 for failure to pay fines and/or costs in a case. Trautman testified that he "would very much like to have a license at some point in the future."

Trautman was actively involved in the firm's daily business. James Wilson, a TWCO registered representative,[16] testified that Trautman, as a name partner, was highly visible within the firm and had hands-on involvement in all aspects of the firm's operations. According to Wilson, Trautman "walked around and spoke to everybody. [He] [w]as involved in personal matters with people [and] professional matters with people. He was involved in the hiring process. He had his fingerprints definitely on [the] firm." TWCO's co-founder and chairman, Samuel Wasserman, echoed this view, stating that "everybody reported" to Trautman.

C. TWCO Establishes New Mutual Fund Market Timing Department

In 2000, in an attempt to increase the firm's business, Wasserman recruited Wilson and Wilson's junior colleague, Scott Christian,[17] to establish a mutual fund market timing department

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[16] In settlement of the OIP's allegations against him, Wilson consented to the entry of a judgment ordering him to cease and desist from committing or causing any violations or future violations of Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5, from causing any violations or future violations of Exchange Act Sections 15(c) and 17(a) and Exchange Act Rules 10b-3 and 17a-3, and from committing or causing any violations or future violations of Investment Company Act Rule 22c-1; barring him from association with any broker or dealer; prohibiting him from serving or acting in various capacities with respect to a registered investment company; imposing disgorgement of $534,160, plus $145,840 in prejudgment interest; and assessing a $120,000 civil penalty. *Trautman Wasserman & Co.*, 92 SEC Docket at 2258.

[17] In July 2005, Christian pleaded guilty in New York state court to a Class E felony for securities fraud. The guilty plea arose out of the same misconduct underlying this proceeding. As part of his plea agreement, Christian agreed to testify and cooperate with the New York Attorney General's ("NYAG") Office and the Commission. Christian also agreed to be barred from association with any broker or dealer pursuant to a follow-on administrative proceeding. *Scott A. Christian*, Exchange Act Rel. No. 52163 (July 29, 2005), 85 SEC Docket 4345.

In April 2007, Wilson pleaded guilty in New York state court to a Class E felony for securities fraud and received a three-year conditional discharge. *People v. Wilson*, No. 04188-2006 (N.Y. Sup. Ct. Apr. 4, 2007). In light of Wilson's plea, in June 2007, Christian was allowed to re-plead to a misdemeanor charge and received an unconditional discharge. *People v. Christian*, No. 03409-2005 (N.Y. Sup. Ct. June 21, 2007). Around this same time, Christian also settled a civil injunctive action brought by the Commission in the United States District Court for the Southern District of New York. *SEC v. Christian*, Civ. No. 05-CV-06239 (LTS) (S.D.N.Y. June 19, 2007). Christian, without admitting or denying the Commission's allegations, consented to the entry of a judgment enjoining him from violations of Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5, and from aiding and abetting

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at TWCO. TWCO had not been engaged in the mutual fund market timing business before Wilson and Christian joined the firm. Wilson and Christian operated as a team, with Wilson acting as the superior and Christian handling day-to-day operations.

In a pre-employment interview, Wilson described to Wasserman his mutual fund market timing business. Wilson stated that, as part of the business, he wanted mutual fund managers to give him market timing "capacity," meaning the ability to gain access to mutual funds and be allowed to freely market time them even if the funds' prospectuses stated that the funds did not allow market timing. Wilson told Wasserman that he could raise a billion dollars in assets through customers with whom he had relationships.

Wilson further told Wasserman that it was important that TWCO's clearing firm be able to support the type of business that he conducted. TWCO cleared its transactions through Bank of America Corporation ("BOA").[18] BOA gave TWCO an instruction manual for processing mutual fund trades. BOA's manual specified that "[a]ll orders should be received and time-stamped [by TWCO] by the close of the NYSE [New York Stock Exchange], 4 p.m. EST [Eastern Standard Time]. With MFRS [Mutual Fund Order Entry System] you will have until 5:15 EST to enter and review those orders time stamped by 4 pm EST." The purpose of the review period was to allow brokers to correct any errors in the orders received by 4:00 p.m. The review period did not provide additional time for brokers to submit new orders, or to confirm, modify, or cancel orders already submitted, after the NYSE's regular trading session closed at 4:00 p.m.

Wilson and Christian met twice with BOA before they joined TWCO in December 2000. Following the second meeting, BOA representative Matthew Augugliaro informed Wilson and Christian privately that BOA's platform would allow TWCO to enter its mutual fund orders directly into BOA's system until 6:30 p.m., but still obtain that day's NAV, and that a hedge fund customer in San Francisco was already using the system to submit trades at 6:30 p.m.[19]

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17 (...continued)
violations of Exchange Act Sections 15(c) and 17(a) and Exchange Act Rules 10b-3 and 17a-3. The final judgment further directed him to pay $250,000 in disgorgement.

18 In February 2005, BOA entered into a settlement with the Commission regarding its facilitation of market timing and late trading by certain introducing broker-dealers. *See Banc of Am. Capital Mgmt.*, Exchange Act Rel. No. 51167 (Feb. 9, 2005), 84 SEC Docket 3046.

19 In a February 2004 report following a cause examination of TWCO, Commission staff found that the MFRS system required mutual fund transactions to be entered individually, but applied no constraints as to the time of entry. According to the staff report, a mutual fund transaction entered into the MFRS system before the final 8:30 p.m. batching time would be transmitted to the National Securities Clearing Corporation's ("NSCC") Fund/SERV (a national

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Trautman testified that BOA representatives Augugliaro and Stuart Heller told him that TWCO's customers would be able to enter orders directly into BOA's system after 4:00 p.m. Trautman stated that he understood that BOA's system "would allow us [TWCO] to bypass faxing tickets to Bank of America for entry[,] [a]nd that we would have the ability . . . to confirm or cancel orders up until cut-off times" of 5:30 p.m. or 6:30 p.m. Trautman claimed that he was unaware that BOA had a policy requiring mutual fund orders to be received and time-stamped by the introducing broker by 4:00 p.m.

D. TWCO's Late Trading and Deceptive Market Timing Scheme

TWCO's market timing customers consisted of eight institutions, Alastor Capital Management ("Alastor"), Beacon Rock Capital ("Beacon Rock"), Canadian Imperial Banking Corporation or Canadian Imperial Holdings Inc. ("CIBC"), DLR Advisors ("DLR"), Folkes Asset Management ("Folkes") (now Headstart Advisers Limited), Johnson Capital Management ("Johnson"), Pentagon Capital Management ("Pentagon Capital"), and Ritchie Capital Management ("Ritchie Capital");[20] two individuals, Jeffrey Augen[21] and Daniel Rosenthal; and a Wilson Trautman Christian ("WTC") proprietary account. TWCO acted as introducing broker in processing customers' mutual fund trades through BOA.

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19 (...continued)
clearing system) with instructions to purchase or sell the funds at the NAV calculated as of 4:00 p.m. that day. Thus, anyone with direct access to the MFRS system had the ability to enter mutual fund orders after 4:00 p.m. but still receive the same day's NAV. Selected BOA customers and correspondent firms, including TWCO, were given direct access to the MFRS system. Direct access also allowed TWCO to enter orders to be batched and transmitted to NSCC without having to submit to the supervisory review provided by BOA's Mutual Fund Operations Department. The February 2004 report was forwarded to the Division of Enforcement.

20 Federal criminal, civil, or administrative actions have been brought against most of TWCO's institutional customers for late trading and/or deceptive market timing activities between 1999 and 2003. *See United States v. Beacon Rock Capital, LLC*, Litig. Rel. No. 20567 (May 12, 2008), 2008 WL 2018278; *SEC v. Headstart Advisers Ltd.*, Litig. Rel. No. 20524 (Apr. 10, 2008), 2008 WL 1004151; *SEC v. Pentagon Capital Mgmt. PLC*, Litig. Rel. No. 20516 (Apr. 3, 2008), 2008 WL 899195; *Ritchie Capital Mgmt. LLC*, Securities Act Rel. No. 8890 (Feb. 5, 2008), 92 SEC Docket 1492; *Canadian Imperial Holdings, Inc.*, Securities Act Rel. No. 8592 (July 20, 2005), 85 SEC Docket 3848.

21 Among other duties, Trautman advised a private equity company named TurboWorx Inc. During the relevant period, Trautman was chairman, and Jeffrey Augen was president and chief executive officer, of TurboWorx.

TWCO's market timing business included late trading, using BOA's processing system. Wilson and Christian admitted that they engaged in late trading and market timing on behalf of TWCO's customers and for the firm's WTC account.[22] TWCO's customers used trading models that gave signals of when they should move their money into or out of the markets. Those signals included changes in the futures markets of more than one and one-half percent and corporate earnings announcements after the NYSE closed at 4:00 p.m. but before 6:30 p.m.

Christian described the typical daily routine for handling mutual fund orders. Between noon and 2:00 p.m., TWCO received proposed orders from Alastor, DLR, Folkes, and Johnson. TWCO did not receive proposed orders from Beacon Rock, Pentagon Capital, Ritchie Capital, and the CIBC, WTC, Augen, and Rosenthal accounts. Rather, TWCO employees generated those orders.

Christian and other TWCO personnel did not time-stamp orders when they were received from the customer or generated by the firm, but waited instead until between 3:45 p.m. and 4:00 p.m. to start time-stamping orders. Christian sometimes forgot to time-stamp orders before 4:00 p.m., resulting in some order tickets time-stamped after 4:00 p.m., so he began to use an alarm clock to remind himself to time-stamp all proposed orders before 4:00 p.m. Christian testified that he time-stamped proposed orders before 4:00 p.m. because he wanted to make it appear as though they were received by the 4:00 p.m. close of the markets, and because his understanding was that all orders had to be time-stamped before 4:00 p.m.

The time-stamped orders were mere place holders for the actual trades made after the markets' close. Christian and other TWCO personnel did not re-stamp order tickets when the actual trading decisions were made after 4:00 p.m. Nor did they create cancelled order tickets for post-4:00 p.m. cancelled trades. In fact, when customers cancelled trades, TWCO personnel threw the original order tickets away. When customers confirmed trades, TWCO personnel entered the orders into BOA's system for processing. All of the confirmed orders received the current day's NAV.

Beacon Rock, Pentagon Capital, Ritchie Capital, and the CIBC, WTC, Augen, and Rosenthal accounts typically confirmed, modified, and/or cancelled orders after 4:00 p.m., up until 5:30 p.m. or 6:30 p.m., at which point Wilson and/or Christian executed the orders and the customers received that day's NAV. From February 2001 to September 2003, TWCO placed a total of approximately 9,500 trades for at least four of these customers -- Beacon Rock, Pentagon Capital; Ritchie Capital, and the WTC account -- in a minimum of eight mutual funds or fund families whose prospectuses stated that NAV was determined at 4:00 p.m. when regular trading on the NYSE closed, and that a trade had to be received by the 4:00 p.m. close in order to obtain

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[22] At the hearing, the law judge asked the parties if there was "any doubt" from Wilson's and Christian's testimony that they admitted "to what we now consider late trading and market timing." Trautman's counsel affirmed that Wilson and Christian admitted to having engaged in late trading and market timing, and stated, "[S]o do we."

that day's NAV.[23] Christian testified that neither he nor anyone else that he knew at TWCO reviewed any of the prospectuses of the mutual funds that TWCO late traded.

By Christian's estimates, seventy-five percent of Pentagon Capital's mutual fund orders, ninety to ninety-five percent of Ritchie Capital's orders, one hundred percent of Beacon Rock's orders, one hundred percent of CIBC's orders, and sixty percent of the WTC account's orders were placed after 4:00 p.m., with each customer receiving the same day's NAV for each order placed after 4:00 p.m. Wilson testified that a "majority" of TWCO's mutual fund trades during the relevant period consisted of late trades, always for the same day's NAV.[24] Wasserman testified that Christian told him that "virtually all" of TWCO's mutual fund trades were late trades.[25]

Wilson and Christian both testified that Trautman knew about the late trading at TWCO. Wilson stated that Trautman was present in his and Christian's office, often sitting in Wilson's chair, when mutual fund orders came in and customers submitted their trading orders, "generally all after 4 o'clock." Christian stated that he and Trautman had extensive, daily discussions about TWCO's late trading. On several occasions, the subject of the legality of the late trading came up in discussions among Wilson, Christian, and Trautman. According to Christian, the three of them referred to TWCO's ability to late trade as taking "advantage" of an "operational loophole" in BOA's processing system, in order to "justify" the trading to themselves.[26]

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23 The eight mutual funds or fund families were: Janus Mercury Fund; Invesco Technology Funds; Alliance Premier Growth; SEI Institutional International Trust; Nations International Equity Fund; Credit Suisse International Focus Fund; Franklin Funds; and Hartford-Fortis Series Fund.

24 Between January 2001 and September 2003, TWCO's mutual fund department executed a total of approximately 81,650 mutual fund trades.

25 The law judge found that Wasserman gave credible testimony. A law judge's credibility findings are entitled to considerable weight and deference. *See, e.g., Warwick Capital Mgmt., Inc.*, Investment Advisers Act Rel. No. 2694 (Jan. 16, 2008), 92 SEC Docket 1410, 1413 n.9.

26 Christian testified: "There were a couple of other times . . . where legal/illegal came up and Jim [Wilson] and I would sit there and we would talk about how we felt about what we were doing every day. And we would justify it [the ability to late trade] to ourselves, call it an operational loophole, make ourselves feel better about what we had just heard or what somebody had said about the business. And I recall Greg Trautman having those conversations with us."

E. TWCO's Practices to Circumvent Mutual Funds' Anti-Market Timing Policies

Christian estimated that he and Wilson conducted between two and three hundred trades per day in a total of over one hundred different mutual fund families. When their mutual fund trading was identified by mutual funds as violating the funds' anti-market timing policies, the funds would send TWCO (or BOA, as TWCO's intermediary) "kick-out" letters freezing accounts and restricting subsequent trading. Between 2001 and 2003, TWCO's mutual fund trading resulted in over three hundred "kick-out" letters from approximately forty mutual fund families. The volume of kick-out letters decreased beginning in mid-2002 when Wilson and Christian started focusing most of their trading in funds that allowed market timing, usually because TWCO had market timing arrangements whereby the funds provided capacity to TWCO in exchange for TWCO customers' maintaining "sticky assets," *i.e.*, long-term investments of capital, in the funds.

To circumvent mutual funds' anti-market timing policies, Christian testified that he and Wilson engaged in a variety of practices to stay "under the radar" of the "mutual fund police," meaning mutual fund internal compliance monitors who sought to identify and prevent market timing trades.[27] Christian's and Wilson's practices included opening multiple accounts for the same customer and creating new registered representative identification numbers to hide their identity from the funds.[28] Christian affirmed that by opening multiple accounts and

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[27] Wilson testified that he did not think that TWCO's mutual fund department engaged "specifically" in "under the radar" practices, but acknowledged that its activities "could be viewed" as such.

[28] Courts, as well as the Commission, have found such practices to be deceptive. *See, e.g., Ficken*, 546 F.3d at 51-52 (finding that the defendant's use of duplicative financial advisor and customer account numbers to deceive mutual funds met the scienter requirement of the federal securities laws' antifraud provisions); *Pentagon Capital Mgmt.*, 612 F. Supp. 2d at 262 (stating that "[t]he systematic use of multiple accounts and broker-dealers to conceal market timing trades from mutual funds may be better described as the use of a fraudulent device"); *SEC v. Gann*, No. Civ. A. 305CV0063L, 2006 WL 616005 (N.D. Tex. Mar. 13, 2006) (denying motion to dismiss complaint for securities fraud where defendants engaged in mutual fund market timing scheme using deceptive practices to avoid detection by mutual funds; deceptive practices included using multiple accounts, multiple registered representative numbers and multiple branch office codes, and dividing trades into smaller dollar amounts); *Michael Sassano*, Securities Act Rel. No. 8945 (July 18, 2008), 93 SEC Docket 7942 (settled proceeding) (finding that respondent engaged in deceptive practices in connection with fraudulent late trading and market timing scheme, including: using multiple accounts, including cloning of new accounts; creating new registered representative numbers to disguise himself and customers from the mutual funds; sending trades from a different branch to deceive mutual funds about the origins of

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continuing to trade, despite mutual funds' efforts to halt the trading, he was deceiving the mutual funds.

F. Trautman's Role in TWCO's Scheme

Trautman claimed that he had "no understanding" of Wilson's and Christian's mutual fund market timing business when TWCO hired them. However, Wilson testified that, during his interviews, he "absolutely" discussed his mutual fund market timing business with both Trautman and Wasserman. Wasserman testified that he was "sure" all of his partners, including Trautman, understood the nature of Wilson's business from its inception at the firm because he would not have started a new business without their "assent or consent," and because either he or Wilson would have explained the business to them.

Trautman testified that he understood that market timing activities could harm mutual funds. As an example, Trautman stated that the "undisclosed and unanticipated rapid buying and selling of securities in a small fund or an illiquid fund could be harmful to the fund manager's ability to manage his portfolio positions." Trautman testified that he knew that there were "bad" market timers or "cowboys" who "would trade hundreds of times a year or trade in and out [of funds] without the fund managers knowing." Trautman also knew that mutual funds sought to monitor or restrict market timing and issued "kick-out" letters to freeze known market timers' accounts and prevent them from trading. In fact, Trautman specifically recalled "one instance" when he was in Wilson's and Christian's office and a "kick-out" letter received by TWCO was discussed.

Trautman admitted that he regularly visited Wilson's and Christian's office "two, three, [or] four times a week" to "educate" himself about their mutual fund market timing business. Trautman testified that he understood that TWCO's customers submitted mutual fund orders before 4:00 p.m. and confirmed or cancelled those orders between 5:30 p.m. and 6:30 p.m.[29]

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[28] (...continued)
the trade; trading in smaller amounts to avoid detection by the funds, including using an in-house electronic trading platform to break up trades into small dollar volumes; and using annuities to avoid restrictions on market timing; and using trading platforms of other broker-dealers to continue market timing mutual funds that blocked their customers' trading).

[29] Counsel for Trautman conceded at the hearing that Trautman "knew at all times that orders were being written up before 4 o'clock and time-stamped, and that after 4 o'clock the hedge fund managers [were] amending -- canceling the order[s] until 5:30 [p.m.]."

However, Trautman denied knowing that mutual fund orders had to be placed by 4:00 p.m. or that regular trading on the NYSE closed at 4:00 p.m.[30]

In his testimony, Trautman characterized the ability of TWCO's customers to confirm or cancel mutual fund orders after 4:00 p.m. as "time arbitrage." Trautman affirmed that TWCO's customers who submitted trading instructions after 4:00 p.m. would receive the same day's NAV, which was determined as of 4:00 p.m., before market news came out. Trautman understood that customers who placed post-4:00 p.m. orders had the "ability to respond to anything that takes place [in the market] up until the point that they had to make their [trading] decision[,] and the longer they had to make the decision[,] the better it was for them." Trautman acknowledged that he understood that TWCO's ability to place post-4:00 p.m. trades was a "selling point" for the firm. However, Trautman denied knowing that TWCO customers' post-4:00 p.m. confirmation or cancellation orders constituted changes to the orders submitted before 4:00 p.m.

Trautman testified that "time arbitrage" trading had been going on for "several years" at TWCO. He thought that TWCO's trading after 4:00 p.m. took advantage of "stale pricing." Trautman did not think that there was anything wrong with "time arbitrage" trading because he knew that "there were serial arbitrage or client strategies . . . relat[ing] to stale pricing that were legal." However, Trautman admitted that he never consulted counsel regarding the legality of TWCO's late trading.

Trautman testified that he heard from Wilson, Christian, and another individual about supposed legal opinions or Commission no-action letters that ostensibly supported the legality of late trading in mutual fund shares.[31] However, as he acknowledged in testimony, Trautman never

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30 The law judge did not believe Trautman when he professed a lack of knowledge of these matters. She found his testimony generally to be not credible because, in her words, it was often "inconsistent and/or false." Trautman has not shown, nor do we find, any substantial evidence contradicting the law judge's credibility findings. *See, e.g., Warwick Capital Mgmt.*, 92 SEC Docket at 1413 n.9.

31 Christian testified that he obtained a copy of a Commission no-action letter from a friend in February 2003 and brought the no-action letter to the office to share with Wilson. Wilson had additional copies of the no-action letter made and left one for Trautman on his desk. Christian "skimmed" the no-action letter, but did not see how it applied to TWCO's mutual fund trading. The no-action letter, which is in the record, discussed the purposes underlying Investment Company Act Rule 22c-1, including the elimination of share dilution resulting from "backward pricing." *See Charles Schwab & Co.*, SEC No-Action Letter, 1997 WL 447915 (July 7, 1997). The no-action letter concluded that a customer order placed with the broker-dealer before a mutual fund's pricing time, typically 4:00 p.m., could receive the price calculated as of the pricing time even if the order was transmitted to the fund after the pricing time. Here,

(continued...)

asked for or looked at any legal opinions or Commission no-action letters during the relevant period. Trautman claimed that it was only after TWCO's receipt of a subpoena in August 2003 in connection with an investigation of mutual fund trading by the NYAG that the trading that he called "time arbitrage" was considered to be late trading. Trautman stated that, before the firm's receipt of a subpoena from the NYAG, he "never reviewed [order] tickets [and] never looked at their [Wilson and Christian's] business" in "detail."

1. Trautman Made Late Trading Decisions

WTC Account. The WTC account was created in December 2001 so that Wilson could have a trading history if TWCO began a hedge fund.[32] The initial investment in the WTC account was approximately $400,000 or $500,000.

Wilson and Christian testified that Trautman made late trading decisions for the WTC account. At first, the WTC account followed or "mimicked" the trading strategy of Alastor, which made its trading decisions before 4:00 p.m. However, subsequently, Trautman, Wilson, and Christian decided to make a trade based on a post-4:00 p.m. earnings announcement. When the strategy proved profitable, they decided that thereafter they would make trading decisions for the WTC account based on post-4:00 p.m. market news, but still obtain the same day's NAV. Christian testified that he and Trautman had daily discussions about which companies were reporting earnings after 4:00 p.m. Wilson testified that Trautman "absolutely" was aware that late trading took place in the WTC account; that Trautman was in charge of trading instructions for the WTC account; that Trautman conferred with Christian regarding different market indicators before making the trading decisions; and that Wilson personally observed Trautman making post-4:00 p.m. trading decisions in the WTC account.[33]

Trautman admitted that he placed mutual fund orders in the WTC account that took advantage of "time arbitrage" trading. Trautman testified that he "regularly" visited Wilson's and Christian's office after 4:00 p.m. to "confirm what we were or were not doing" in the WTC account. Trautman recalled that he also discussed stock futures trading and the markets in

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31 (...continued)
by contrast, the customer orders were placed with and transmitted by TWCO after the pricing time.

32 Trautman testified that the account was called the Wilson Trautman Christian account "because the three of us were going to be involved in formulating the strategy and building the hedge fund platform."

33 On one occasion when Trautman was unavailable, Wilson and Christian asked Wasserman to make the late trading decisions for the WTC account. According to Wilson, Wasserman demurred and told them that "that was Greg[] [Trautman's] responsibility."

general with Christian. Trautman testified that he generally "confirmed" trades for the WTC account at 5:30 p.m. or 6:00 p.m., after market moving information came out, that he "broadly" knew the day's NAV when he made his confirmations, and that he received a "stale price" (the same day's NAV) for the trades.[34] Trautman stated that he was asked to "confirm" trades in the WTC account "maybe a dozen times."

Augen. In December 2002, Trautman solicited Jeffrey Augen to open an account at TWCO to be used for late trading. Trautman informed Augen that he had a strategy of investing in mutual funds using a "trigger," *i.e.*, when the price of stock futures contracts rose by one and one-half percent in post-4:00 p.m. trading. Augen understood that Trautman's trading strategy permitted trading decisions up to 6:30 p.m., and that the trades would receive the price determined at 4:00 p.m. the same day.[35] Augen testified that Trautman represented that he had made money on thirteen out of fifteen trades using this strategy.

In or about January 2003, Augen and his wife opened a joint account at TWCO and invested $250,000. Augen testified that he decided to pursue Trautman's strategy because it had a two and one-half hour advantage after the markets closed, not typically available to public customers, that would enable Augen to buy mutual fund shares at the 4:00 p.m. price using information after the markets' close.

Augen and his wife testified that Trautman made the trading decisions for their TWCO account. They also testified that Trautman suggested that they give him discretion to trade the account so that Trautman did not have to obtain their approval for trades and could ensure that the Augens would be able to late trade on any given trading day. Augen closed the TWCO account in July 2003 because he was not sure that he agreed with Trautman's strategy and was losing money.

Trautman agreed that he had discussions with Augen that resulted in Augen investing money in a joint account at TWCO. However, Trautman did not recall the specifics of those discussions. Trautman acknowledged that he confirmed trades in the Augen account after 4:00 p.m. and that the "final confirmation time" was 5:30 p.m. or 6:30 p.m.

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34 In 2004 sworn investigative testimony, Trautman denied that he ever placed a mutual fund order after 4:00 p.m. However, he did "remember cancelling an error after 4 o'clock, once, on a trade." Trautman also denied that he "personally" ever went long in mutual fund shares based on earnings announcements after 4:00 p.m.

35 Augen testified that Trautman referred to his trading strategy as TWCO's "secret sauce." According to Augen, "there were two ingredients to the secret sauce. One ingredient [was] the relationship that allows them [TWCO] to sweep the money at 6:30 [p.m.] at night using the 4 o'clock price, the agreement with Bank of America. And the other ingredient would be the trigger that was used for it."

CIBC. CIBC invested three to four million dollars in an account at TWCO. Wilson testified that Trautman made the trading decisions for, and late traded in, the CIBC account. Trautman affirmed that he made trading decisions for the CIBC account. Trautman explained that Christian would call him to "confirm" an order and Trautman would "okay or reject" that order after 4:00 p.m.[36] Trautman affirmed that trades for the CIBC account were placed at the same time as those for the WTC account. Trautman testified that, in his mind, there was no distinction between the CIBC and WTC accounts.

Ritchie Capital. In March or April 2001, at Wilson's request, Trautman introduced Ritchie Capital to Janus Funds through his friend Warren Lammert, portfolio manager of the Janus Mercury Fund.[37] Trautman admitted that he understood that the purpose for making the introduction was to obtain market timing capacity for Ritchie Capital's TWCO account. However, Trautman denied that he understood at the time that TWCO's customers would use capacity obtained from the Janus Funds to engage in "time arbitrage" trading with "stale pricing."

The prospectus for the Janus Funds, including the Janus Mercury Fund, stated that "[a] fund's NAV is calculated at the close of the regular trading session of the NYSE (normally 4:00 p.m. New York time) each day that the NYSE is open. In order to receive a day's price, your order must be received by the close of the regular trading session of the NYSE." Trautman

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36 When asked if he made trade confirmations or cancellations in the CIBC account at 5:30 p.m. or 6:30 p.m., Trautman replied, "I honestly don't recall ever doing it [post-4:00 p.m. confirmations or cancellations] for the CIBC account, although my testimony is not that I didn't. I think once it [the CIBC account] was set up to mimic the WTC account[,] to me[,] the calls were still the WTC account." As noted previously, the law judge did not credit Trautman's testimony.

37 The Commission instituted and settled civil administrative proceedings against Janus Capital Management for allowing certain parties to conduct market timing in mutual funds it managed during the period from 2001 to 2003. *See Janus Capital Mgmt., LLC,* Investment Advisers Act Rel. No. 22771 (Aug. 18, 2004), 83 SEC Docket 2034. The Commission also brought administrative proceedings against Warren Lammert for his role in market timing transactions in the Janus Funds' mutual funds. A law judge found that Lammert was a cause of Janus Funds' violations of Securities Act Sections 17(a)(2) and 17(a)(3), Section 206(2) of the Investment Advisers Act of 1940, and Investment Company Act Section 34(b), and entered a cease-and-desist order against him. *See Warren Lammert*, Initial Decision Rel. No. 348 (Apr. 28, 2008), 93 SEC Docket 5676. We declared that decision final. *Warren Lammert*, Exchange Act Rel. No. 57882 (May 29, 2008), 93 SEC Docket 6185.

testified that he never reviewed any public documents issued by any of the mutual funds that TWCO traded.[38]

Despite the requirements in the prospectus, Trautman effected a $100 million late trade in the Janus Mercury Fund on behalf of Ritchie Capital. Christian testified that, one evening around 6:00 p.m., "there was a news event, the futures were rallying," and Ritchie Capital called and asked if it could move its money into the Janus Mercury Fund. Christian relayed Ritchie Capital's request to Trautman. Trautman, with Christian present, called Lammert and asked if Ritchie Capital could make the trade. Trautman testified that Lammert inquired, "[I]s that possible[?]," to which Trautman replied, "[Y]es, in our system we can put our orders up until 5:30 [p.m.] or 6:30 [p.m.]." Trautman testified that once he told Lammert "what our system was capable of doing," Lammert said that the trade "wouldn't be a problem." Trautman informed Christian that it was "okay" with Lammert. At Trautman's direction, Christian entered an order on Ritchie Capital's behalf for $100 million. Christian affirmed that Ritchie Capital received the price calculated at 4:00 p.m. that day, even though the trading decision was made after the 4:00 p.m. pricing time.

2. Trautman Deceptively Negotiated and Secured Market Timing Capacity

As discussed, "capacity" in the mutual fund market timing business was the ability to gain access to mutual funds and to be allowed to freely market time the funds. Christian testified that obtaining market timing capacity was important because it allowed TWCO to "grow" its assets by bringing in new business with customers.[39] It also allowed TWCO to market time "freely" in the funds without having to open multiple accounts and without receiving "kick-out" letters. TWCO developed a list of mutual funds that gave it capacity and allowed it to market time the funds. TWCO used the capacity it obtained for late trading.

TWCO's partners, including Trautman, participated in Wilson's and Christian's efforts to obtain capacity from mutual funds. Christian testified that he expected that capacity obtained by TWCO's partners would be used for late trading. Christian also testified that at meetings he attended TWCO's partners sought to secure capacity from mutual funds by representing that TWCO's style of market timing was beneficial and not harmful to the funds.

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[38] Prospectuses are public documents issued by mutual funds. *In re Merrill Lynch & Co., Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 247 n.2 (S.D.N.Y. 2003) (finding that fund prospectus was properly considered in determining motion to dismiss because it was a public document and was filed with the SEC).

[39] TWCO earned fees from its customers based on the amount of assets held under management. Generally speaking, the more assets that TWCO had under management, the greater the revenues generated for the firm.

Alliance Technology Fund. Christian testified that TWCO's customers market timed approximately $90 million in the Alliance Technology Fund.[40] TWCO conducted late trading in the Alliance Technology Fund for Beacon Rock, Pentagon Capital, and Ritchie Capital. TWCO's customers did not trade frequently in the Alliance Technology Fund, but were able to trade the fund profitably because they were trading on earnings announcements and news events that occurred after 4:00 p.m.

In the spring of 2003, the Alliance Technology Fund decided to no longer permit market timing in that fund. Christian and Wilson were concerned about the loss of timing capacity due to TWCO's "huge investment" in the Alliance Technology Fund. Using Wasserman's close relationship with an Alliance executive, Trautman and Christian arranged a meeting in May 2003 with Alliance Technology Fund's portfolio manager, Gerald Malone, in order to seek an exception and to continue market timing the funds.

Although Trautman was aware that TWCO's customers market timed and late traded the Alliance Technology Fund, at the meeting he falsely informed Malone that TWCO's customers did not trade frequently in the Alliance Technology Fund and conducted their trading in a way that was helpful to the fund's management. Trautman and Christian did not disclose to Malone that TWCO's practice was to trade after hours in the Alliance Technology Fund and obtain the same day's price for the trades.

After the meeting, Trautman wrote Malone a follow-up e-mail reiterating his claims that TWCO's trading in the Alliance Technology Fund was beneficial and seeking permission to remain in the Fund. Trautman also thanked Malone for "consider[ing] the possibility of figuring out a way to work together." Again, Trautman did not disclose to Malone that TWCO engaged in late trading in the Alliance Technology Fund.

Federated Funds. In the summer of 2003, TWCO sought capacity from representatives of Federated Funds. Trautman and other TWCO personnel, including Wilson and Christian, asserted to Federated Funds that TWCO's trading activities could benefit Federated Funds. In an e-mail, Federated Funds' James Power Gordon, Jr. rejected TWCO's arguments for capacity. Gordon concluded that market timing had a negative impact on mutual fund returns and could be harmful to the funds. In a responsive e-mail, Trautman indicated that he thought that Gordon's analysis overstated the long-term impact of market timing on mutual funds. Trautman also stated that TWCO did not consider its mutual fund trading to be market timing. Trautman further argued that TWCO's approach to mutual fund trading, which included providing "an extra

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[40] The Commission instituted and settled civil administrative proceedings against Alliance Capital Management for certain market timing trading activities in the Alliance mutual fund complex during 2001 to 2003. *See Alliance Capital Mgmt., LLC*, Investment Advisers Act Rel. 2205A (Jan. 15, 2004), 81 SEC Docket 4221.

cushion to the [portfolio] manager," would "create[] a positive for all sides."[41] Trautman did not disclose in his communications to Federated Funds that TWCO and its customers were using capacity to engage in late trading. Federated Funds gave capacity to TWCO to trade its funds.[42] TWCO was unable to use the capacity obtained from Federated Funds due to the onset of the NYAG's mutual fund trading investigation.

3. Trautman Made False Representations Regarding the Legality of the Late Trading

Beacon Rock. In early 2002, Christian and Wilson met with Beacon Rock to offer Beacon Rock access to TWCO's late trading platform. Beacon Rock indicated that it might be interested in investing $100 to $200 million with TWCO to pursue the late trading strategy. Christian conveyed this information to Trautman. In March 2002, Beacon Rock opened an account at TWCO. By the end of May 2002, Beacon Rock had invested $63.6 million with TWCO. As stated previously, all of Beacon Rock's trades through TWCO were late trades.

In July 2002, Blake Singer, a Beacon Rock principal, and Kelly Hollingsworth, Singer's independent consultant, met with Trautman, Wasserman, Wilson, and Christian at TWCO's offices. Singer stated that he and Hollingsworth wanted to get more comfortable with TWCO's late trading platform. The uniform testimony of Wilson, Christian, and Hollingsworth was that the meeting concerned TWCO's late trading.[43]

Hollingsworth testified that during the meeting TWCO personnel focused mainly on the mechanics of the late trading, prompting her to remark that this "tells [her] why the trad[ing] is possible, but it doesn't explain to [her] why the trad[ing] is legal." According to Hollingsworth, Trautman represented that TWCO's internal compliance department and outside counsel had

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[41] Trautman's e-mail stated, in part, that, "[f]orgetting for a second that we [TWCO] do not consider our activity to be 'market timing," the "long term impact [on mutual funds] of a number of short term trades actually approache[d] a negligible number." The e-mail suggested that "even a negligible impact" could be a "positive" that would "help[,] [and not] hurt[,] [Federated Funds'] performance."

[42] The Commission instituted and settled civil administrative proceedings against Federated Funds for its late trading and deceptive market timing activities in 2003 and earlier years. *See Federated Inv. Mgmt. Co.*, Exchange Act Rel. No. 52839 (Nov. 28, 2005), 86 SEC Docket 2441.

[43] Singer did not testify at the hearing.

reviewed the late trading, leading her to believe that TWCO's late trading had been approved by both and was legal.[44]

In addition, Christian testified that Trautman specifically stated at the meeting that BOA's system provided the opportunity after 4:00 p.m. to cancel, change, or amend orders placed before 4:00 p.m.; that this was an "operational loophole" in the system; and that he, Trautman, did not have an issue with a customer confirming an order previously submitted before 4:00 p.m. because it was a function of the system.

Trautman denied that Singer and Hollingsworth specifically asked about the legality of placing a mutual fund order before 4:00 p.m and then cancelling or confirming the order after 4:00 p.m, although he admitted that their questions "encompassed" that activity. Trautman also denied that he falsely represented that TWCO had consulted with outside counsel concerning the legality of the trading. The law judge credited Hollingsworth's version of events because, as stated previously, she found that Trautman's testimony was often "inconsistent and/or false."

Following the July 2002 meeting, Beacon Rock continued to late trade through TWCO. At a subsequent meeting in March 2003, Singer informed Wilson, Christian, and Wasserman of Beacon Rock's plan to raise significantly more money to pursue the late trading strategy through TWCO.

Augen. Augen testified that Trautman represented that late trading was a "common practice" among Wall Street investment bankers, done through agreements between banks (specifically referring to TWCO's relationship with BOA), and was "completely legal."

4. Trautman Sought to Continue Some Late Trading After TWCO Received a Subpoena

In August 2003, after TWCO received a subpoena from the NYAG regarding its mutual fund trading, Wilson and Trautman discussed TWCO's late trading and Trautman indicated that TWCO might have violated the securities laws. Wilson testified that he believed that Trautman was "panicked" due to the "massive amount of income" that potentially would be lost if TWCO's customers could not late trade.

Wilson testified that he and Trautman discussed how TWCO could continue late trading for Ritchie Capital, the firm's most "sophisticated" customer and largest account. Christian

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44 During oral argument, Trautman's counsel represented that Wasserman testified that "that [Hollingsworth's version of the meeting] never happened." The record shows that at the hearing, Wasserman admitted that Singer asked about late trading. However, Wasserman testified that "[t]he late trading that he [Singer] was asking to be done in my mind . . . had nothing to do with when you would make a decision, but it was entering orders from an operational point of view, could that be done after the [markets'] close."

testified that Trautman was "fearful" that Ritchie Capital would "take [its] assets back" because it could no longer late trade through TWCO. Trautman indicated that he "couldn't run the firm" if, in the coming weeks, the income generated by Ritchie Capital's account was "going to disappear." In an attempt at damage control, Christian testified that Trautman came up with the idea of "optics" as a way to continue some late trading for Ritchie Capital but conceal it from the regulators. According to Christian, Trautman used the word "optics" to mean "how things were going to appear" to the regulators.

Ritchie Capital ceased late trading through TWCO, despite Trautman's efforts. Ritchie Capital agreed to a 4:00 p.m. cut-off time for its mutual fund trading in exchange for reduced management fees charged by TWCO. Thereafter, the NYAG publicly announced its investigation into mutual fund trading. "[A]t that point[,]" Christian testified, "we knew everything was done."

G. TWCO's Revenues from the Scheme

Wilson testified that he regularly discussed the profitability of TWCO's mutual fund department with TWCO's partners, including Trautman, and that they knew of and were excited about its successes.[45] Trautman affirmed that he knew that Wilson and Christian generated a "substantial amount of revenue" for the firm. Trautman also knew that Wilson's business was "very successful" and grew to be "very large."

Commission staff examiners and the Division's expert calculated that for the years 2001, 2002, and the first nine months of 2003, TWCO had gross revenues of approximately $32.5 million, including approximately $22.6 or $22.7 million in mutual fund revenues.[46] TWCO's mutual fund revenues thus accounted for approximately seventy percent of its gross revenues during the relevant period. After paying Wilson and Christian,[47] TWCO received forty percent of the $22.6 million in mutual fund revenues, or approximately $9,040,000. The $9,040,000 was

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45 Wilson testified that he and TWCO's partners engaged in "friendly bantering" regarding "the profitability of the [mutual fund] department and how much money was coming in." Wilson stated that there were times when he joked that his business was "keeping the lights on" at the firm.

46 The record does not explain the reason for the discrepancy between the $22.6 and $22.7 million figures. For purposes of this opinion, we use the $22.6 million figure.

47 Wilson received sixty percent of the mutual fund revenues minus a portion of prorated expenses. Wilson's compensation was approximately $1.4 million in 2001, $5.5 million in 2002, and $3.5 million in 2003, for a total of approximately $10.4 million. Christian received a salary of $36,000 and medical benefits from TWCO, as well as a percentage of Wilson's share of the mutual fund revenues. Christian's compensation was $210,624 in 2001, $740,125 in 2002, and $884,019 in 2003, for a total of approximately $1.8 million.

invested in TWCO, TW Holding Company,[48] and the private equity companies advised by the firm; the partners received salaries but no bonuses. TWCO CFO Barbara testified that the "vast majority" of the firm's mutual fund revenues was used not only to fund business operations but also to pay for expenses such as salaries, overhead, health benefits, and rent.

A comparison of TWCO's mutual fund revenues with its gross revenues for 2001 to 2005 is set forth below:

Year	Mutual Fund Revenues	Gross Revenues
2001	5,769,120	8,492,975
2002	9,955,909	13,267,450
2003	8,841,213	12,284,437
2004	2,042,163	6,548,211
2005	882,798	4,801,212

TWCO's mutual fund revenues declined following New York state and federal regulatory investigations into misconduct in the trading of mutual fund shares, beginning in September 2003.

In his affidavit, the Division of Enforcement's expert concluded that "market timing and specifically late trading strategies most likely generated the orders for most of" TWCO's trades between 2001 and 2003. The expert based this conclusion on the short periods between purchases and subsequent sales and on the strong correlations between purchases and subsequent price increases.[49] The expert further concluded that TWCO's customers' trading was "extraordinarily successful" because mutual fund prices rose on the day following approximately sixty percent of their purchases but fell following only nearly thirty-four percent of the purchases. (Prices did not change on the remaining six percent of purchases.) The expert found that TWCO's trading caused approximately $102.7 million in dilution losses to mutual funds and their shareholders.

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48 Wasserman testified that TWCO's portion of the mutual fund revenues may have been used to pay debts of TW Holding Company, which was 100% owned by Trautman.

49 The expert calculated that the average trade size was $535,134 and that customers began to sell fifty percent of the positions they purchased within two trading days of purchase and sold ninety percent within eight trading days. The expert opined that the frequent trading and short holding periods were characteristic of the execution of market timing and late trading strategies.

III.

A. Trautman's Primary Liability

The OIP charged Trautman with primary violations of the antifraud provisions of the securities laws -- Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5 -- based on his participation in TWCO's late trading and deceptive market timing scheme. Securities Act Section 17(a), which proscribes fraudulent conduct in the offer or sale of securities, and Exchange Act Section 10(b) and Exchange Act Rule 10b-5, which proscribe fraudulent conduct in connection with the purchase or sale of securities, prohibit essentially the same type of conduct.[50] To find Trautman primarily liable under Securities Act Section 17(a)(1), Exchange Act Section 10(b), and Exchange Act Rule 10b-5, it must be shown that Trautman engaged in fraudulent conduct, that such conduct was in connection with the offer, sale, or purchase of securities,[51] and that he acted with scienter.[52] Scienter is not required to prove a violation of Securities Act Sections 17(a)(2) and 17(a)(3); instead, a showing of negligence is sufficient.[53]

1. Trautman's Fraudulent Conduct

To establish that Trautman engaged in fraudulent conduct, he must have: (1) made an untrue statement of material fact;[54] (2) omitted a fact that made a prior statement misleading; or

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50 *See United States v. Naftalin*, 441 U.S. 768, 778 (1979); *see also, e.g., SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996), *cert. denied*, 522 U.S. 512 (1997).

51 The United States Supreme Court has embraced an expansive interpretation of Exchange Act Section 10(b)'s "in connection with" language and Securities Act Section 17(a)'s "in the offer or sale" language. *See, e.g., Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 85 (2006); *SEC v. Zandford*, 535 U.S. 813, 819 (2002); *Naftalin*, 441 U.S. at 773. Trautman does not dispute that those requirements have been met.

52 *SEC v. Tambone*, 417 F. Supp. 2d 127, 131 (D. Mass. 2006) (citing *Aaron v. SEC*, 446 U.S. 680, 695 (1980) and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976)).

53 *Aaron*, 446 U.S. at 697 & 701-02; *Weiss v. SEC*, 468 F.3d 849, 855 (D.C. Cir. 2006).

54 A fact is material if there is a substantial likelihood that a reasonable investor would have considered the misstated or omitted fact important in making an investment decision, and if disclosure of the misstated or omitted fact would have significantly altered the total mix of information available to the investor. *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

(3) committed a deceptive or manipulative act as part of a scheme to defraud.[55] Late trading in mutual funds is a scheme to defraud.[56] Mutual funds are defrauded into believing that trades were submitted before the 4:00 p.m. close of regular trading when, in fact, they were submitted with the benefit of market moving information after the 4:00 p.m. close, thereby causing funds to provide improper prices for the trades.[57]

Trautman committed primary violations of Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5 based on his knowing or reckless participation in a fraudulent scheme. Trautman, as TWCO's co-owner, president, and chief executive officer, engaged in numerous deceptive acts as part of the scheme. Trautman personally engaged in the late trading; deceptively sought market timing capacity from Alliance Technology Fund and Federated Funds by materially misrepresenting the nature of TWCO's trading and its impact on the funds; and fraudulently induced Beacon Rock and Augen to invest or to continue investing with TWCO by falsely assuring them of the legality of the late trading, all in furtherance of the late trading aspect of the scheme.[58]

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55 *Tambone*, 417 F. Supp. 2d at 131-32. *See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008) (stating that it would be "erroneous" to suggest that "there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5"; emphasizing that "[c]onduct itself can be deceptive"); *see also Burnett v. Rowzee*, 561 F. Supp. 2d 1120, 1125 (C.D. Cal. 2008) (stating that under a theory of scheme liability, "relevant deceptive acts include[] deception as part of a larger scheme to defraud the securities market"; further, a deceptive act is one that has "the principle purpose and effect of creating a false appearance of fact in furtherance of the scheme") (internal quotations and citations omitted).

56 *See In re Mut. Funds Inv. Litig*, 384 F. Supp. 2d at 856 & n.10.

57 *See Simpson Capital Mgmt.*, 586 F. Supp. 2d at 204-05 (denying motion to dismiss complaint alleging late trading scheme in violation of Exchange Act Section 10(b) and Exchange Act Rule 10b-5; complaint sufficiently alleged that defendants engaged in "deceptive conduct" where their acts communicated the "false impression" to mutual funds that trades were submitted before 4:00 p.m. when, in fact, they were submitted with the benefit of market news after 4:00 p.m.).

58 *See United States v. Finnerty*, 533 F.3d 143, 148 (2d Cir. 2008) (observing that "deceptive conduct" within the meaning of Exchange Act Section 10(b) "irreducibly entails some act that gives . . . a false impression"); *see also SEC v. Dorozhko*, 574 F.3d 42, 50 (2d Cir. 2009) (stating that, "[i]n its ordinary meaning, 'deceptive' covers a wide spectrum of conduct involving cheating or trading in falsehoods," but noting the holding of the Fifth Circuit in *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 389 (5th Cir. 2007)).

Trautman personally engaged in the late trading. Trautman admitted that he made trading decisions for the WTC, Augen, and CIBC accounts at 5:30 p.m. or 6:30 p.m., using post-4:00 p.m. market information, and that he obtained a "stale price" for the trades. At Trautman's direction, TWCO personnel entered Trautman's trades into BOA's system as though they were received before 4:00 p.m. Trautman acknowledged that, at least with respect to the WTC account, he effected post-4:00 p.m. trades "maybe a dozen times." Trautman further acknowledged that, on behalf of Ritchie Capital, he arranged a $100 million trade in the Janus Mercury Funds after 4:00 p.m. Trautman effected the $100 million trade even though Janus Mercury Fund's prospectus required that orders had to be received by the 4:00 p.m. close of trading on the NYSE in order to obtain the same day's NAV. Christian affirmed that he entered the $100 million trade for processing after 4:00 p.m. and that Ritchie Capital obtained the same day's NAV for the trade. The submission of mutual fund trades after the 4:00 p.m. close of trading constituted materially false representations that the trades were received by TWCO before 4:00 p.m., where those trades received the same day's NAV.[59] By directing TWCO to enter the mutual fund trades effected after 4:00 p.m. as if they actually were received before 4:00 p.m., Trautman deceived mutual funds into providing improper prices for the trades.

Trautman materially misrepresented the nature of TWCO's trading and its impact on mutual funds when he sought to obtain market timing capacity from Alliance Technology Fund and Federated Funds. Trautman falsely stated to Federated Funds that TWCO did not consider its mutual fund trading to be market timing, despite the fact that TWCO's primary trading strategies involved market timing. Trautman also falsely characterized TWCO's trading as beneficial to Alliance Technology Fund and Federated Funds when, in fact, he knew that TWCO used capacity obtained from funds to engage in late trading, which harmed the funds by diluting the value of their shareholders' investment.[60] By materially misrepresenting the nature of TWCO's trading and its impact on the mutual funds, Trautman sought to evade mutual funds' anti-market timing restrictions and conceal TWCO's late trading from the funds.[61] That this

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59 The misrepresentations were material because a reasonable investor would have considered it important to know whether and to what extent the daily NAV of a particular mutual fund was diluted by late trading.

60 *See SEC v. Druffner*, 517 F. Supp. 2d 502, 508 (D. Mass. 2007) (granting Commission's motion for summary judgment in enforcement action against stock broker for engaging in market timing activities through false statements and intentional misrepresentations in violation of federal securities laws' antifraud provisions; finding that defendant materially misrepresented the nature of his and brokerage team's transactions to mutual funds through use of fictitious financial advisor numbers and accounts, with intent to evade detection by mutual fund managers), *aff'd sub nom. SEC v. Ficken*, 546 F.3d 45 (1st Cir. 2008).

61 Trautman's false statements regarding the nature of TWCO's trading and its impact on the mutual funds were material because a reasonable investor would have wanted to

(continued...)

objective was achieved is reflected in part by Federated Funds' agreement to give TWCO capacity and allow TWCO to market time its funds.[62]

Trautman fraudulently induced customers to invest or to continue investing with TWCO by falsely assuring them of the legality of the late trading, an activity that was a selling point for the firm. Trautman's business strategy for TWCO required customers' continued investment with the firm and participation in the trading. Trautman's false assurances to customers furthered the deceptive scheme by encouraging them to continue investing more money with TWCO in order to pursue the late trading strategy.

Trautman falsely represented to Beacon Rock's Singer and Hollingsworth that TWCO's late trading had been reviewed by outside counsel and internal compliance when there were no legal or compliance opinions that supported the firm's late trading. Trautman also falsely stated to Singer and Hollingsworth that the late trading was permissible because of an "operational loophole" in BOA's system, despite the fact that, pursuant to BOA's mutual fund processing manual, mutual fund orders had to be received by TWCO before 4:00 p.m. in order to receive the same day's NAV. Based on Trautman's false statements, Beacon Rock continued to late trade through TWCO and determined to invest more money with TWCO to pursue the late trading strategy.

Trautman falsely stated to Augen that the opportunity to buy mutual fund shares at the 4:00 p.m. price, using market information after 4:00 p.m., was possible because of TWCO's relationship with BOA and was "completely legal." However, Trautman obtained no legal analysis from inside or outside TWCO to support the firm's late trading operations. Based on Trautman's false statements, Augen invested $250,000 in a joint account at TWCO. Trautman's purpose in making material misrepresentations to Augen and Beacon Rock was to further the late trading scheme.[63]

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[61] (...continued)
know that the firm and its customers were using market timing capacity and engaging in unlawful late trading.

[62] That TWCO was unable to use the capacity obtained from Federated Funds due to the onset of the NYAG's mutual fund trading investigation is of no moment here. An action brought by the Commission, unlike a private damage suit, need not include proof of harm. *See Graham v. SEC*, 222 F.3d 994, 1001 n.15 (D.C. Cir. 2000); *Schellenbach v. SEC*, 989 F.2d 907, 913 (7th Cir. 1993); *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985).

[63] Trautman's misrepresentations were material because a reasonable investor would have considered the illegality of the late trading to be an important factor in deciding whether to invest or to continue investing with TWCO.

2. Trautman's Scienter

Trautman acted with scienter. Scienter is a mental state embracing an intent to deceive, manipulate, or defraud.[64] It includes recklessness, defined in this context as "an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the [respondent] or so obvious that the [respondent] must have been aware of it."[65]

Trautman knew that TWCO's mutual fund department regularly engaged in market timing and, specifically, late trading activities, and admitted that it had been doing so for "several years." Trautman had frequent discussions with Wilson and/or Christian about TWCO's late trading. Trautman admitted that he knew that customers generally placed orders before 4:00 p.m. on any given trading day, and then confirmed or cancelled those orders after 4:00 p.m., up until 6:30 p.m., at which point TWCO personnel entered them into the system for processing. Trautman understood that the benefit to customers in submitting trading instructions after 4:00 p.m. was that they had more time than the rest of the market to make their trading decisions and were able benefit from information that became available after 4:00 p.m. Trautman also understood that by engaging in such trading, TWCO customers were able to take advantage of "stale prices" on their trades. Trautman further understood that TWCO's mutual fund department was "very successful" and generated substantial revenues for the firm.

Trautman not only knew of TWCO's late trading activities, but he also observed them taking place. Wilson testified that Trautman was present in his and Christian's office, often sitting in Wilson's chair, as customers' mutual fund orders came in after 4:00 p.m. Trautman admitted that he regularly visited Wilson's and Christian's office at 6:00 p.m. or 6:30 p.m. when, by all accounts, customers' mutual fund orders were received and entered.

Furthermore, Trautman personally engaged in the late trading. Trautman admitted that he made trading decisions for the WTC, Augen, and CIBC accounts based on post-4:00 p.m. market information, knowing that TWCO would obtain a "stale price" for the trades. Trautman recalled discussing post-4:00 p.m. trading in the futures markets with Christian before making his trading decisions. Trautman also admitted that he effected a $100 million late trade in the Janus Mercury Fund on behalf of Ritchie Capital. Trautman directed Christian to enter the $100 million trade after 4:00 p.m., knowing that Ritchie Capital would receive the NAV calculated as of 4:00 p.m. that day, in contravention of the prospectus requirement.

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64 *Ernst & Ernst*, 425 U.S. at 193 n.12.

65 *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 704 (7th Cir. 2008) (quoting *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 76 (2d Cir. 2001)); *see also, e.g., SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992) (quoting *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977)). Proof of scienter may be demonstrated by circumstantial evidence. *Herman & Maclean v. Huddleston*, 459 U.S. 375, 390-91 n.30 (1983); *Valicenti Advisory Servs., Inc. v. SEC*, 198 F.3d 62, 65 (2d Cir. 1999).

Trautman knew, or was reckless in not knowing, that the late trading that he and TWCO engaged in was illegal. BOA's instruction manual and the prospectuses of many mutual funds which Trautman and TWCO traded required that mutual fund orders be received before 4:00 p.m. in order to obtain that day's NAV. While Trautman claimed that he never saw BOA's manual and never read the public documents of any mutual funds, those materials provided clear notice of what was required for an investor to receive the current day's NAV. At a minimum, Trautman recklessly turned a blind eye to those requirements. In doing so, his conduct constituted "an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to [Trautman] or so obvious that [Trautman] must have been aware of it."[66]

Trautman testified that he knew that market timing strategies could be harmful to mutual funds. Trautman understood that the "undisclosed and unanticipated rapid buying and selling of securities in a small fund or an illiquid fund could be harmful to the fund manager's ability to manage his portfolio positions." Trautman also understood that there were "bad" market timers who "trade[d] hundreds of times a year or trade[d] in and out [of mutual funds] without the fund managers knowing." Trautman further understood that mutual funds sought to prevent or restrict market timing and took measures against known market timers.

Trautman testified that he heard from Wilson, Christian, and another individual that there were legal opinions or Commission no-action letters ostensibly supporting TWCO's late trading operations. However, Trautman made no attempt to obtain and/or read any legal opinions or Commission no-action letters. In fact, Trautman knew that there was substantial doubt about the legality of TWCO's late trading because it was the subject of numerous conversations of which he was a part. Christian testified that, with Trautman present, he and Wilson had discussions about the "legal/illegal" aspect of TWCO's late trading. Christian testified that the three of them attributed TWCO's ability to late trade to an "operational loophole" in BOA's system, in order to "justify" the trading to themselves.

Trautman's knowledge that there were at least substantial questions about the legality of TWCO's late trading did not prevent him from falsely representing to customers that the late trading was proper and legal. As discussed, Trautman represented to Beacon Rock's Singer and Hollingsworth that both outside counsel and internal compliance had reviewed the practice of late trading. Trautman told Augen that TWCO's late trading ability was due to its relationship with BOA and was "completely legal." By his own admission, however, Trautman did not consult with counsel, compliance, or anyone else regarding the propriety of TWCO's late trading. Trautman's failure to follow-up and investigate the propriety of the late trading in the face of substantial doubt as to its legality constituted at least recklessness.

Even after the NYAG issued a subpoena to TWCO in August 2003 and Trautman indicated to Wilson that TWCO might have acted illegally, Trautman suggested continuing the

[66] *Makor Issues & Rights*, 513 F.3d at 704.

late trading for Ritchie Capital on a limited basis. Trautman's actions in urging that Ritchie Capital continue some late trading, but conceal it from the regulators through "optics" that would hide post-4:00 p.m. trades, is compelling evidence that he acted at all times with a high degree of scienter.

Given his extensive experience in the securities industry and numerous securities licenses, his position as co-founder, president, and chief executive officer of a small firm that earned approximately seventy percent of its gross revenues during the relevant period from mutual fund trading, and his direct, hands-on management of all aspects of the firm's operations, Trautman must have known that illegal late trading was taking place at TWCO. We find that Trautman is primarily liable for his active and intimate involvement in the scheme,[67] which generated more than $22 million in mutual fund revenues for TWCO between 2001 and 2003. We conclude that Trautman willfully[68] violated Securities Act Section 17(a)(1), Exchange Act Section 10(b), and Exchange Act Rule 10b-5.[69]

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67 *See, e.g., Pentagon Capital Mgmt.*, 612 F. Supp. 2d at 859-60 & n.3 (holding that allegations of defendants' role in alleged late trading scheme as its creators, directors and chief beneficiaries were sufficient to subject defendants to primary antifraud liability and survived motion to dismiss complaint; stating that "the allegations that Defendants here were the architects of the alleged scheme are sufficient, but not necessary, to plead liability as primary violators of the securities laws"); *In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d at 858 (holding that defendants alleged to have been involved in fraudulent scheme from the outset, to have been at least one of its architects, and to have received profits that were siphoned off of mutual funds as a result of late trades and market timed transactions were subject to primary antifraud liability); *In re Blech Sec. Litig.*, 961 F. Supp. 569, 585-86 (S.D.N.Y. 1997) (holding that a claim for primary liability under Exchange Act Section 10(b) was sufficiently stated where plaintiff alleged that defendant "directed," "contrived," and participated in the initiation and clearing stages of certain alleged fraudulent transactions); *see also, e.g., SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 112 (2d Cir. 1998) (holding that stock trader could be primarily liable under Exchange Act Section 10(b) for following stock promoter's directions to execute trades that trader knew, or was reckless in not knowing, were manipulative, even if he did not share promoter's overall purpose to manipulate the market for that stock; finding that trader personally committed manipulative acts when he effected the very buy and sell orders that artificially manipulated the stock price upward).

68 A willful violation of the securities laws means the intentional commission of an act that constitutes the violation; there is no requirement that the actor must be aware that he is violating any statutes or regulations. *See Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000).

69 We reject Trautman's claim, made in reliance on *Upton v. SEC*, 75 F.3d 92 (2d Cir. 1996), that our interpretation of late trading violates due process because he did not have fair notice that his conduct would constitute regulatory violations. "Due process requires . . . only

(continued...)

Trautman claimed that he thought that the late trading was legal because he "broad[ly]" understood that mutual funds calculated and publicly posted their NAVs around 6:00 p.m. or 6:30 p.m. According to Trautman, because TWCO's customers usually placed their orders by 5:30 p.m. or 6:30 p.m., before the public posting of NAVs, those orders properly received the NAVs calculated at 4:00 p.m. that day. However, if, as Trautman claimed, there was a lawful time between 4:00 p.m. and the public posting of NAVs to submit orders, then presumably TWCO would have implemented procedures to keep track of the times when NAVs were publicly posted and orders were submitted, and TWCO or Trautman would have maintained documents that evidenced those procedures. Not surprisingly, the record shows that no such procedures were in place and that no such documents were produced. Indeed, Trautman admitted that he did not know of any system at TWCO that either tracked when the funds' NAVs were made public or indicated whether customers' confirmations and cancellations were made before NAVs were posted. Furthermore, the testimony of mutual fund representatives established that, while the actual calculation and public posting of NAVs could occur one or two hours after the close of the markets at 4:00 p.m., all mutual fund trading orders had to be received by a mutual fund's intermediary by 4:00 p.m. in order to obtain that day's NAV.

B. Trautman's Secondary Liability

In addition to charging that Trautman willfully violated Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5, the OIP charged that Trautman willfully aided and abetted, and was a cause of, TWCO's violations of Exchange Act Section 15(c) and Exchange Act Section 10b-3, which prohibit broker-dealers from effecting transactions in, or inducing or attempting to induce, the purchase or sale of securities by means of a manipulative, deceptive, or other fraudulent device or contrivance.[70]

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[69] (...continued)
that 'laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited.'" *Valicenti Advisory Servs.*, 198 F.3d at 66 (quoting *Upton*, 75 F.3d at 98). Trautman, an experienced securities professional, cannot "credibly claim lack of fair notice of the proscription against defrauding investors." *Id.*

We also reject Trautman's claim, made in his petition for review, that the law judge's "surprise use of uncharged facts" constituted an "impermissible amendment of the OIP without the required notice" to him. Our review of the record reveals that there was no "surprise use" of "uncharged facts," and that the OIP was not amended at any time. We find that throughout these proceedings the law judge acted consistently with our Rules of Practice and due process requirements.

[70] The scienter standards that apply to violations of Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5 also apply to violations of Exchange Act Section 15(c)(1) and Exchange Act Rule 10b-3. *See, e.g., Darvin v. Bache Halsey Stuart*

(continued...)

The elements of aiding and abetting liability are: (1) a securities law violation by another party; (2) the alleged aider and abetter generally was aware or knew that his actions were part of an overall course of conduct that was improper or illegal; and (3) the alleged aider and abettor substantially assisted in the primary violation.[71] We have held that recklessness is sufficient to satisfy the scienter requirement for aiding and abetting liability.[72]

TWCO committed primary violations of Exchange Act Section 15(c) and Exchange Act Rule 10b-3. The record shows that TWCO engaged in a scheme to defraud mutual funds and their shareholders through late trading and deceptive market timing. As discussed, Wilson and Christian admitted that, while at TWCO, they engaged in late trading and deceptive market timing activities, thereby defrauding mutual funds and their shareholders.

Trautman, as TWCO's president and chief executive officer, substantially assisted in the firm's primary violations. Trautman was a hands-on manager who left his "fingerprints" on all aspects of the firm's operations. Trautman agreed to TWCO's hiring of Wilson and Christian and its establishment of a mutual fund market timing department. Trautman regularly met with Wilson and Christian several times a week and discussed their market timing strategies. As discussed, Trautman acknowledged that the revenues that Wilson and Christian generated were "substantial," in fact accounting for seventy percent of TWCO's gross revenues during the relevant period. Trautman was present when late trading occurred and personally made late trading decisions in the WTC, Augen, CIBC, and Ritchie Capital accounts.

In addition, Trautman deceptively sought market timing capacity from Alliance Technology Fund and Federated Funds by falsely characterizing TWCO's trading activities as not market timing and as beneficial to the funds. Furthermore, Trautman falsely assured Beacon

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70 (...continued)
Shields, Inc., 479 F. Supp. 460, 464 (S.D.N.Y. 1979); *Fundamental Portfolio Advisors, Inc.*, 56 S.E.C. 651, 670 & n.35 (2003).

71 *See, e.g., Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004); *Graham*, 222 F.3d at 1000; *Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952, 956 (7th Cir. 2004); *Ross v. Bolton*, 904 F.2d 819, 824 (2d Cir. 1990). A person cannot escape aiding and abetting liability by claiming ignorance of the federal securities laws. *See Sharon M. Graham*, 53 S.E.C. 1072, 1084 n.33 (1998), *aff'd*, 222 F.3d 994 (D.C. Cir. 2000).

72 *See Graham*, 53 S.E.C. at 1080-85 & n.33; *Russo Sec., Inc.*, 53 S.E.C. 271, 278-79 & n.16 (1997). The District of Columbia Circuit Court of Appeals has held that "extreme recklessness" may support aiding and abetting liability "if the alleged aider and abettor encountered red flags or suspicious events creating reasons for doubt that should have alerted him to the improper conduct of the primary violator, or if there was a danger so obvious that the alleged aider and abettor must have been aware of it." *Howard*, 376 F.3d at 1143 (internal quotations and citations omitted).

Rock and Augen regarding the legality of the late trading so that they would invest or continue to invest their assets with and trade through TWCO.[73] Our findings with respect to Trautman's scienter in the context of his primary liability establish that he had the requisite knowledge that his actions were part of an overall course of conduct that was improper or illegal, as required for secondary liability. We conclude that Trautman willfully aided and abetted, and was a cause of,[74] TWCO's primary violations of Exchange Act Section 15(c) and Exchange Act Rule 10b-3.[75]

IV.

A. Statute of Limitations

As an initial matter, we note that the OIP issued on February 5, 2007. The five-year statute of limitations set forth in 28 U.S.C. § 2462 commenced on February 5, 2002.[76] Section 2462 precludes our consideration of Trautman's conduct occurring before February 5, 2002 in determining whether to impose a bar or civil penalty.[77] Such conduct may be considered, however, to establish Trautman's motive, intent, or knowledge in committing violations that are

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[73] Trautman's actions were a substantial factor in causing TWCO's primary violations and therefore satisfy the Second Circuit Court of Appeals' proximate cause requirement for the "substantial assistance" element of aiding and abetting liability. *See, e.g.*, *Pentagon Capital Mgmt.*, 612 F. Supp. 2d at 266; *SEC v. Treadway*, 430 F. Supp. 2d 293, 339 (S.D.N.Y. 2006). We note, however, that the District of Columbia Circuit Court of Appeals has not adopted a proximate cause requirement. *See SEC v. Johnson*, 530 F. Supp. 2d 296, 303 n.7 (D.D.C. 2008).

[74] One who aids and abets a violation also is a cause of the violation under the federal securities laws. *See Graham*, 53 S.E.C. at 1085 n.35.

[75] In light of our findings of primary and secondary liability under the antifraud provisions of the securities laws, *see generally* 6 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation*, § 20.5 (6th ed. 2009) (stating that "[e]ven in the absence of an express rule prohibiting late trading, the SEC has made clear that late trading is improper and violates the [antifraud provisions of the] securities laws"), we do not decide Trautman's secondary liability for aiding and abetting, and being a cause of, TWCO's clearing firm BOA's violations of Investment Company Act Rule 22c-1.

[76] *See Johnson v. SEC*, 87 F.3d 484, 492 (D.C. Cir. 1996) (holding that Section 2462's five-year limitations period applied to certain Commission administrative proceedings).

[77] *See Terry T. Steen*, 53 S.E.C. 618, 623-25 (1998).

within the limitations period.[78] Further, we may consider the entirety of Trautman's conduct in deciding whether to impose a cease-and-desist or disgorgement order because such an order operates prospectively and is not subject to Section 2462.[79]

B. Bar from Association

Exchange Act Section 15(b)(6) authorizes us to censure, place limitations on, suspend, or bar a person associated with a broker or dealer if we determine that the person has, among other things, willfully violated the federal securities laws and it is in the public interest to do so.[80] We have indicated that, in determining what sanction is in the public interest, we consider the factors in *Steadman v. SEC.*[81] Those factors include the egregiousness of a respondent's actions, the degree of scienter involved, the isolated or recurrent nature of the infraction, the recognition of the wrongful nature of the conduct, the sincerity of any assurances against future violations, and the likelihood that the respondent's occupation will present opportunities for future violations.[82] We have also stated that conduct that violates the antifraud provisions "is especially serious and subject to the severest sanctions."[83]

Trautman's conduct while associated with a broker-dealer was egregious. He participated in a late trading and deceptive market timing scheme that defrauded many mutual funds and their shareholders. The fraudulent scheme generated at least $22 million in illicit profits for TWCO and caused dilution losses to mutual fund shareholders of more than $102 million. As set forth above, Trautman's conduct demonstrated a high degree of scienter. Trautman's conduct was not an isolated incident, but a recurrent pattern that extended over a substantial period of time and stopped only after it was detected by regulators. He has not offered assurances against future violations, nor has he recognized that he committed serious antifraud violations. Trautman's provision of consulting services to unidentified companies raises questions about his potential to

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78 *Id.* at 624; *see also Joseph J. Barbato*, 53 S.E.C. 1259, 1278 (1999); *Graham*, 53 S.E.C. at 1089 n.47.

79 *See Edgar B. Alacan*, 57 S.E.C. 715, 743 (2004).

80 15 U.S.C. § 78o(b)(6).

81 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981).

82 *Id.*

83 *Justin F. Ficken*, Investment Adviser Act Rel. No. 2803 (Oct. 17, 2008), 94 SEC Docket 10887, 10891 & n.20 (citing cases).

commit future violations.[84] Trautman also affirmed his desire to continue working in the securities industry. These factors, coupled with his disciplinary history,[85] lead us to conclude that a bar from association with any broker or dealer is necessary to protect the public interest and will serve a remedial purpose.

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84 At the hearing, Trautman testified that, although he did not have full-time employment, he was optimistic that he would find consulting work. On appeal, Trautman submitted sworn financial statements indicating that he has been providing consulting services. Moreover, in an affidavit filed with his reply brief and sworn to on May 21, 2008, Trautman attested that he "performed one consulting project this year for which [he] received about $20,000 in public securities."

85 In 2002, Trautman executed a Letter of Acceptance, Waiver, and Consent ("AWC") with NASD, without admitting or denying the allegations, for carrying on a securities business through TWCO while failing to maintain minimum required net capital, in violation of Exchange Act Section 15(c), Exchange Act Rule 15c3-1, and NASD Conduct Rule 2110, and was jointly and severally fined $5,000. The Commission has "long recognized that [a respondent's] prior disciplinary history is to be considered in fashioning a sanction." *Consolidated Inv. Servs.*, 52 S.E.C. 582, 591 (1996). In reviewing that history, we have considered orders in both settled and litigated proceedings. *Russo Sec., Inc.*, 55 S.E.C. 58, 82 n.61 (2001); *see also, e.g.*, *Pagel, Inc. v. SEC*, 803 F.2d 942, 948 (8th Cir. 1986) (holding that the Commission did not abuse its discretion in revoking broker-dealer's registration and barring it from association with any broker or dealer where, *inter alia*, broker-dealer previously had been sanctioned for other securities law violations pursuant to offer of settlement).

While the Division relies on two other previously-settled disciplinary matters, our review of the record indicates that it failed to introduce into evidence the related settlement documents. The only evidence regarding the prior disciplinary settlements is a Central Registration Depository Information report and an NASD complaint. We have held that an offer of settlement may not be considered for purposes of disciplinary history where "the plain language of the consent order unequivocally states that it may not be used in another proceeding." *See R. B. Webster Invs., Inc.*, 51 S.E.C. 1269, 1278 n.37 (1994); *Howard R. Perles*, 55 S.E.C. 686, 711-12 & n.41 (2002). In the absence of the actual settlement documents, we are unable to determine whether the plain language of the prior disciplinary settlements precludes their use in this proceeding. As a result, we have not considered those disciplinary matters against Trautman. In all events, we believe that the conduct evidenced here alone warrants the full sanctions imposed.

C. Cease-and-Desist Order

Securities Act Section 8A(a) and Exchange Act Section 21C authorize the Commission to impose a cease-and-desist order if it finds that any person has violated the federal securities laws or rules thereunder.[86] In determining whether a cease-and-desist order is appropriate, we look to whether there is some risk of future violations.[87] The risk of future violations required to support a cease-and-desist order is significantly less than that required for an injunction.[88] A single violation can be sufficient to indicate some risk of future violations.[89] Our finding that a violation is egregious "raises an inference that it will be repeated."[90] We also consider whether other factors demonstrate a risk of future violations, including the seriousness of the violation, the isolated or recurrent nature of the violation, whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, the respondent's state of mind, the sincerity of assurances against future violations, the recognition of the wrongfulness of the conduct, the opportunity to commit future violations, and the remedial function to be served by a cease-and-desist order in the context of any other sanctions sought in the proceeding.[91] This inquiry is flexible, and no single factor is dispositive.[92]

We find that the risk of future violations is high. Trautman's conduct was serious and recurrent. He engaged in deceptive conduct that spanned a substantial period of time. His violations were relatively recent and involved a high degree of scienter.[93] Trautman profited

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86 15 U.S.C. §§ 77A(a), 78u-3.

87 *KPMG Peat Marwick, LLP*, 54 S.E.C. 1135, 1185, *reconsideration denied*, 55 S.E.C. 1 (2001), *petition denied*, 289 F.3d 109 (D.C. Cir. 2002).

88 *KPMG Peat Marwick*, 54 S.E.C. at 1191.

89 *See Geiger v. SEC*, 363 F.3d 481, 489 (D.C. Cir. 2004).

90 *Id.*

91 *KPMG Peat Marwick*, 54 S.E.C. at 1192.

92 *Id.*

93 *See Rita J. McConville*, Exchange Act Rel. No. 51950 (June 30, 2005), 85 SEC Docket 3127, 3152 (imposing cease-and-desist order based on "relatively recent" conduct that occurred more than five years prior to issuance of Commission's opinion), *petition denied*, 465 F.3d 780 (7th Cir. 2006), *cert. denied*, 128 S. Ct. 48 (2007); *Robert W. Armstrong, III*, Exchange Act Rel. No. 51920 (June 24, 2005), 85 SEC Docket 3011, 3040 (imposing cease-and-desist order based on conduct that occurred more than twelve years prior to issuance of Commission's

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substantially from his deceptive conduct at the expense of mutual fund investors, who suffered significant losses because the late trading and deceptive market timing diluted the value of their shares. Although we have ordered that Trautman be barred from associating with any broker or dealer, the issuance of a cease-and-desist order will serve the remedial purpose of encouraging him to take his responsibilities more seriously in the future should he be allowed to re-enter the securities industry or should he act in a capacity that does not require registration. Therefore, in addition to a bar, it is in the public interest to impose a cease-and-desist order.

D. Disgorgement

Securities Act Section 8A(e), Exchange Act Section 21B(e), and Exchange Act Section 21C(e) authorize disgorgement, including reasonable prejudgment interest, in a cease-and-desist proceeding and a proceeding in which a civil money penalty may be imposed.[94] Disgorgement is an equitable remedy designed to deprive wrongdoers of their unjust enrichment and to deter others from similar misconduct.[95] "[T]he amount of disgorgement should include all gains flowing from the illegal activities."[96]

When calculating disgorgement, "separating legal from illegal profits exactly may at times be a near-impossible task."[97] As a result, disgorgement "need only be a reasonable approximation of profits causally connected to the violation."[98] Once the Division shows that its disgorgement figure is a reasonable approximation of the amount of unjust enrichment, the burden shifts to the respondent to demonstrate that the Division's estimate is not a reasonable approximation.[99] Where disgorgement cannot be exact, the "well-established principle" is that the

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93 (...continued)
opinion; noting that, although the age of the violations militated against imposition of cease-and-desist order, "this consideration [was] outweighed by the other factors" discussed in the opinion).

94 15 U.S.C. §§ 77h-1(a), 78u-2(e), 78u-3(e).

95 *See Zacharias v. SEC*, 569 F.3d 458, 471-72 (D.C. Cir. 2009) (citing *SEC v. First City Fin. Corp., Ltd.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989) and *SEC v. Bilzerian*, 29 F.3d 689, 697 (D.C. Cir. 1994), among other cases).

96 *SEC v. JT Wallenbrock & Assocs.*, 440 F.3d 1109, 1114 (9th Cir. 2006) (quotations and citation omitted).

97 *First City Fin. Corp.*, 890 F.2d at 1231.

98 *Id.*

99 *SEC v. Lorin*, 76 F.3d 458, 462 (2d Cir. 2006); *First City Fin. Corp.*, 890 F.2d at 1232.

burden of uncertainty in calculating ill-gotten gains falls on the wrongdoer whose illegal conduct created that uncertainty.[100]

The Division requests that we order Trautman to disgorge his compensation from TWCO during the relevant period. Although counsel suggested at oral argument that Trautman's salary was $20,000 per month, Trautman submitted a "Schedule of Compensation" as an exhibit to his reply brief on appeal that indicates that, from 2001 to 2003, Trautman received $1,373,777.65 in total compensation from TWCO.[101] We find that ordering disgorgement will deprive Trautman of his unjust enrichment and deter others from similar misconduct, but we do not believe that all of his compensation is a reasonable measure of the amount of unjust enrichment causally connected to the violations.

Trautman participated in an illegal late trading and deceptive market timing scheme that substantially harmed mutual funds and their shareholders by causing approximately $102.7 million in dilution losses. The scheme enabled TWCO to generate approximately $22.6 million in mutual fund revenues. The $22.6 million constituted nearly seventy percent of TWCO's gross revenues of $32.5 million. After paying Wilson and Christian, TWCO retained forty percent of the $22.6 million, or around $9,040,000. A "majority" or "virtually all" of TWCO's mutual fund trades constituted late trades.

TWCO's CFO Barbera testified that the "vast majority" of the $9,040,000 was used to fund TWCO's operations and to pay firm expenses such as salaries, overhead, health benefits, and rent. Trautman testified similarly that TWCO's portion of the mutual fund revenues was used in the growth and development of the business and paid its operating expenses. Trautman also affirmed that TWCO had more money and resources as a result of the mutual fund revenues. In Trautman's words, "there was clearly a benefit for the firm that Christian and Wilson generated commissions."[102]

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[100] *Zacharias*, 569 F.3d at 472; *see also, e.g., SEC v. Calvo*, 378 F.3d 1211 (11th Cir. 2004) ("Exactitude is not a requirement; so long as the measure of disgorgement is reasonable, any risk of uncertainty should fall on the wrongdoer whose illegal conduct created that uncertainty.").

[101] The Division relied on a substantially similar schedule, created by TWCO CFO Barbera and admitted into evidence, to contend that Trautman's total compensation during the relevant period was $1,373,799.95. The Division did not explain how it arrived at the $1,373,799.95. We have determined to use the total amount reflected by Trautman's schedule, $1,373,777.65, which is $22.10 less than the amount sought by the Division. We arrived at this figure by adding the W-2 and 1099 income listed on the schedule for the years 2001 through 2003. Trautman attested in his May 21, 2008 affidavit that this schedule was accurate as to him.

[102] We reject Trautman's argument that he received no personal financial benefit from the mutual fund trading. Disgorgement has been found to be appropriate where ill-gotten gains

(continued...)

TWCO's chairman Wasserman testified that the mutual fund revenues were "important" to TWCO's continued viability as a broker-dealer. The central importance of the mutual fund revenues to TWCO's operations was perhaps best illustrated by Trautman's conduct immediately following the firm's receipt of the subpoena from the NYAG. A "panicked" Trautman became "fearful" about the "massive amount of income" that potentially would be lost due to TWCO's inability to late trade, and suggested continuing some late trading for Ritchie Capital, which had the largest account, but concealing it from the regulators. Trautman indicated that he "couldn't run the firm" if, in the coming weeks, the income generated by Ritchie Capital's account was "going to disappear."

Trautman was a hands-on manager who left his "fingerprints" on all aspects of TWCO's operations, including its illegal late trading. During the scheme, the salary reported on his W-2 forms rose from $100,756.76 in 2001 to $240,000 in 2002 and $231,971.38 in 2003. Once the scheme ended, the salary reported on his W-2 forms declined to $39,426.53 in 2004 and $25,000 in 2005. Barbera testified that partners' salaries declined because TWCO "had substantial legal bills [incurred in connection with regulatory investigations] and of course lower revenues." It thus appears that the scheme enabled Trautman to continue drawing hundreds of thousands of dollars in salary and kept TWCO's business afloat.[103]

Under all the circumstances, we find that fifty percent of Trautman's 2001 compensation, fifty percent of his 2002 compensation, and fifty percent of nine months of his 2003 compensation (represented by three-fourths of that compensation), for a total of approximately $608,886, is a reasonable approximation of his unjust enrichment. The fifty percent measure reflects a ratio of approximately 50:50 between the illegitimate mutual fund revenues that TWCO retained, which were around $9,040,000 (representing TWCO's portion of the $22.6 million in mutual fund revenues after paying Wilson, Christian, and expenses) and the legitimate non-

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102 (...continued)
have been used to sustain business operations. *Terence Michael Coxon*, 56 S.E.C. 934, 967 (2003), *aff'd*, 137 Fed. Appx. 975 (9th Cir. 2005).

103 *See, e.g., SEC v. Conaway*, No. 2:05-CV-40263, 2009 WL 902063, at *20 (E.D. Mich. Mar. 31, 2009) (denying defendants' motions for summary judgment on disgorgement; stating that "[m]aintaining a fraudulent scheme so that one may continue to reap the benefit of a salary or other employment related benefits is enough to support a disgorgement order"); *SEC v. Church Extension of the Church of God, Inc.*, 429 F. Supp. 2d 1045, 1050 (S.D. Ind. 2005) (ordering defendants to disgorge one half of their base salaries for last full year of corporation's operations, plus interest, as proceeds from their securities law violations where the fraud enabled them to continue their employment); *cf. SEC v. First Pac. Bancorp.*, 142 F.3d 1186, 1192 (9th Cir. 1998) (affirming district court order holding defendant jointly and severally liability with corporate co-defendants for disgorgement where the fraud allowed defendant, as chairman, chief executive officer, and corporate counsel, to continue drawing hundreds of thousands of dollars in salaries, commissions, and consulting, management and legal fees).

mutual fund revenues, which were around $9.9 million (representing the difference between the $32.5 million in gross revenues and the $22.6 million in mutual fund revenues), and is intended to take into account certain mitigating factors, for instance, that Trautman provided some legitimate services to TWCO.[104] Accordingly, we order Trautman to disgorge $608,886, plus prejudgment interest calculated pursuant to Section 6621(a)(2) of the Internal Revenue Code,[105] and compounded quarterly.[106]

E. Civil Penalty

Exchange Act Section 21B authorizes the Commission to impose a civil money penalty where a respondent has willfully violated any provision of the federal securities laws and a penalty is in the public interest.[107] Exchange Act Section 21B establishes a three-tiered system of civil penalties, each with a larger maximum penalty amount applicable to increasingly serious misconduct.[108] The factors we consider in assessing the penalty required in the public interest are whether there was fraudulent misconduct, harm to others, or unjust enrichment, whether the respondent had prior violations, and the need for deterrence, as well as such other matters as justice may require.[109] The law judge imposed third-tier penalties of $500,000 on Trautman.

We find third-tier penalties appropriate in response to Trautman's misconduct. The Exchange Act provides that we may impose third-tier penalties where the misconduct "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" and "directly or indirectly resulted in substantial losses or created a significant risk of substantial

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104 *See Church Extension*, 429 F. Supp. 2d at 1050 (stating that order requiring defendants' disgorgement of one-half of base salaries was "intended to reflect in an equitable way the fact that both defendants also provided real and valuable services to [the corporation and subsidiary] for many years, as well as other mitigating factors").

105 26 U.S.C. § 6621(a)(2).

106 Rule of Practice 600(b), 17 CFR § 201.600(b). "[E]xcept in the most unique and compelling circumstances, prejudgment interest should be awarded on disgorgement, among other things, in order to deny a wrongdoer the equivalent of an interest free loan from the wrongdoer's victims." *Coxon*, 56 S.E.C. at 971.

107 15 U.S.C. § 78u-2.

108 *Id.*

109 *Id.*

losses to other persons or resulted in substantial pecuniary gain to the person who committed" the misconduct.[110]

The maximum third-tier penalty for misconduct by a natural person committed during the relevant period was $120,000 for each violation.[111] We have decided to impose civil penalties based on the totality of Trautman's fraudulent misconduct. Trautman engaged in the late trading of mutual fund shares. He also engaged in deceptive acts designed to facilitate the late trading. His late trading and other fraudulent activities directly or indirectly caused over $102 million in dilution losses to mutual fund shareholders and resulted in over $22 million in revenues to his firm. We consider a total penalty of $120,000, along with the other sanctions imposed, to be sufficient to deter future violations of the securities laws.

F. Trautman's Arguments Against Sanctions

Trautman argues that he is "destitute" and cannot pay disgorgement, interest, or civil penalties.[112] For the first time in these proceedings, he offers sworn financial statements purporting to document his financial situation.[113] Under Rule of Practice 630(a), we may, in our discretion, consider evidence of ability to pay in determining whether a respondent should be required to pay disgorgement, interest, or civil penalties.[114] Ability to pay, however, is only one factor that informs our determination and is not dispositive.[115] "Even when a respondent

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110 *Id.*

111 Violations committed by a natural person after February 2, 2001, but before February 14, 2005, have a maximum penalty per occurrence of $6,500 in the first tier; $60,000 in the second tier; and $120,000 in the third tier. *See* Debt Collection Improvement Act of 1996, Pub. L. No. 104-134, 110 Stat. 1321-373 (1996) (codified at 28 U.S.C. § 2461 note); 17 C.F.R. § 201.1002.

112 Trautman represents that he is a widower with three minor children, one of whom has significant medical issues.

113 The law judge below rejected Trautman's asserted inability to pay because he failed to provide sworn financial statements to the Division before the hearing or to introduce a sworn financial statement as part of his direct case at the hearing. *Trautman Wasserman & Co.*, 92 SEC Docket at 1481.

114 17 C.F.R. § 201.630(a).

115 *Id.*, Comment (a) (stating that, "[a]lthough no statutory requirement addresses inability to pay disgorgement or interest, the Commission considers evidence of inability to pay as a factor in determining whether a respondent should be required to pay disgorgement and interest as well as penalties"); *see, e.g., Brian A. Schmidt*, 55 S.E.C. 576, 597-98 (2002) (noting

(continued...)

demonstrates an inability to pay, we have discretion not to waive the penalty, [disgorgement, or interest,] particularly when the misconduct is sufficiently egregious."[116]

We have reviewed the financial statements submitted by Trautman. Even accepting those statements at face value,[117] we find that the egregiousness of Trautman's conduct outweighs any

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115 (...continued)
that, under Exchange Act Section 21B, ability to pay a penalty is but one factor to consider in determining whether a penalty is in the public interest); *see also, e.g., SEC v. Warren*, 534 F.3d 1368, 1370 (11th Cir. 2008) (per curiam) (stating that "at most" a defendant's ability to pay is one factor to be considered in imposing a civil money penalty or disgorgement for violations of the federal securities laws).

116 *Philip A. Lehman*, Exchange Act Rel. No. 54660 (Oct. 27, 2006), 89 SEC Docket 536, 543.

117 The financial information that Trautman submitted on appeal is vague, incomplete, and/or unsubstantiated in a number of respects. *See, e.g., David Henry Disraeli*, Exchange Act Rel. No. 57027 (Dec. 21, 2007), 92 SEC Docket 852, 883 (finding that the "vague and unsubstantiated nature of [the respondent's] disclosures render them neither adequate nor credible as a basis for reducing the disgorgement or penalty amounts"), *aff'd*, 2009 WL 1791547 (D.C. Cir. June 19, 2009) (per curiam) (unpublished); *Lehman*, 89 SEC Docket at 549 (finding that respondent's claim of inability to pay "neither adequate nor credible because his assertions variously are vague, unsubstantiated, inconsistent, or contradicted by reliable evidence"). For example, Trautman submitted federal tax returns only for years 2001 through 2004, even though Section K.1 of the Commission's financial disclosure form requires the submission of federal tax returns from the year of the first violation alleged against the respondent to the present time. In the May 21, 2008 affidavit, Trautman stated that he "did not file 2005, 2006, or 2007 tax returns, but the IRS [Internal Revenue Service] has estimated [his] taxes due for 2005 and 2006 based on [his] 1099s and W2s." He did not provide any documentation showing estimated income for those years, nor did he indicate whether the IRS also estimated his taxes for 2007.

Trautman failed to attach "financial statements that [he] prepared for any purpose . . . in the year of the first violation alleged against [him] and all subsequent years," as required by Section K.3 of the Commission's financial disclosure form. In the May 21, 2008 affidavit, Trautman stated, "I have no copies of any prepared statement during the period. I did prepare one for the IRS but did not retain a copy."

Trautman claimed $10,000 per month in current income on his financial statements, but gave no details as to the source, which was described generally as "consulting fees." In the May 21, 2008, affidavit, Trautman stated, "I performed one consulting project this

(continued...)

discretionary waiver of disgorgement, prejudgment interest, and/or penalties.[118] Ordering Trautman to pay disgorgement of $608,886, plus prejudgment interest, and a single third-tier penalty of $120,000 is necessary to deter others from defrauding mutual funds and their shareholders through illegal and deceptive trading practices.

Trautman also argues that the sanctions imposed against him are inappropriate compared to the sanctions imposed on other respondents, citing specifically to the $250,000 that Christian paid in his settlement with the Commission.[119] It is well-established that the determination of appropriate remedial action depends on the facts and circumstances of each case and cannot be determined by comparison with the actions taken in other proceedings.[120] "Moreover, parties that settle disciplinary proceedings often receive less severe sanctions than those who do

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[117] (...continued)
year, for which I received about $20,000 in public securities." No further information was supplied.

At the hearing, Trautman claimed that there were approximately ten or eleven private equity companies in which TWCO had invested that potentially could provide him with "some level of capital gain or income" in the future. Trautman represented that one (unidentified) private equity company "went public and I got 30 grand. So that could happen again. I'm cautiously hopeful that it will." However, he did not indicate when this occurred. While Trautman testified that he believed he gave the Division an "itemized list" of those private equity companies, our review of the record did not reveal any list.

[118] *See, e.g., Disraeli*, 92 SEC Docket at 883 (finding that respondent's misconduct was sufficiently egregious and outweighed any financial information submitted in support of his asserted inability to pay the disgorgement and penalty amounts) & n.125 (collecting cases); *see also, e.g., Warren*, 534 F.3d at 1370 (finding that nothing in the securities laws or decisional law prohibits a district court from imposing a penalty or disgorgement in excess of a securities law violator's ability to pay; holding that district court acted within its discretion in ordering the defendant to pay disgorgement, interest, and a penalty, even assuming an inability to pay, where such inability to pay did not merit significant weight in comparison to the other equities).

[119] *See supra* n. 17.

[120] *See Butz v. Glover Livestock Comm'n Co.*, 411 U.S. 182, 187 (1973) (stating that "[t]he employment of a sanction within the authority of an administrative agency is thus not rendered invalid in a particular case because it is more severe than sanctions imposed in other cases"); *Geiger*, 363 F.3d at 488 (stating that "[t]he Commission is not obligated to make its sanctions uniform, so we will not compare this sanction to those imposed in previous cases").

not."[121] Accordingly, we reject Trautman's argument that we should reduce his sanctions based on those imposed in settlements with other individuals who engage in deceptive trading practices.

An appropriate order will issue.[122]

By the Commission (Chairman SCHAPIRO and Commissioners CASEY, WALTER, AGUILAR and PARADES).

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E Harmon
Deputy Secretary

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[121] *Ficken*, 94 SEC Docket at 10893 & n.31 (citing cases).

[122] 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 ACT OF 1933
Rel. No. 9088 / December 15, 2009

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 61167 / December 15, 2009

Admin. Proc. File No. 3-12559

In the Matter of

GREGORY O. TRAUTMAN

c/o Leon Baer Borstein
Borstein & Sheinbaum
420 Lexington Avenue, Suite 2920
New York, New York 10170

ORDER IMPOSING REMEDIAL SANCTIONS

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

ORDERED that Gregory O. Trautman be, and he hereby is, barred from association with any broker or dealer; and it is further

ORDERED that Gregory O. Trautman cease and desist from committing or causing any violations or future violations of Section 17(a) of the Securities Act of 1933, Sections 10(b) and 15(c) of the Exchange Act of 1934, and Exchange Act Rules 10b-3 and 10b-5; and it is further

ORDERED that Gregory O. Trautman disgorge $608,886, plus prejudgment interest of $260,645.29, such prejudgment interested calculated beginning from October 1, 2003, in accordance with Commission Rule of Practice 600; and it is further

ORDERED that Gregory O. Trautman pay a civil money penalty in the amount of $120,000.

Payment of the amount to be disgorged and the civil money penalty shall be: (i) made by United States postal money order, certified check, bank cashier's check, or bank money order; (ii) made payable to the Securities and Exchange Commission; (iii) mailed or delivered by hand to the Office of Financial Management, Securities and Exchange Commission, Operations

Center, 6432 General Green Way, Alexandria, VA 22312; and (iv) submitted under cover letter that identifies the respondent and the file number of this proceeding. A copy of the cover letter and check shall be sent to Paul G. Gizzi, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, 4th Floor, New York, NY 10281.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 232

[RELEASE NO. 33-9087; File No. S7-23-09]

RIN 3235-AK44

EXTENSION OF FILING ACCOMMODATION FOR STATIC POOL INFORMATION IN FILINGS WITH RESPECT TO ASSET-BACKED SECURITIES

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Commission is adopting an amendment to Rule 312 of Regulation S-T to extend its application for one year. Rule 312 provides a temporary filing accommodation for filings with respect to asset-backed securities that allows static pool information required to be disclosed in a prospectus to be provided on an Internet Web site under certain conditions. Under the rule, such information is deemed to be included in the prospectus included in the registration statement for the asset-backed securities. As a result of the extension, the rule will apply to filings with respect to asset-backed securities filed on or before December 31, 2010.

EFFECTIVE DATE: This amendment is effective December 31, 2009.

FOR FURTHER INFORMATION CONTACT: John Harrington, Attorney-Adviser, Division of Corporation Finance, at (202) 551-3430, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTARY INFORMATION: We are adopting an amendment to Rule 312[1] of Regulation S-T.[2]

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[1] 17 CFR 232.312.

I. BACKGROUND AND DISCUSSION OF THE AMENDMENT

In December, 2004, we adopted new and amended rules and forms to address the registration, disclosure and reporting requirements for asset-backed securities ("ABS") under the Securities Act of 1933[3] (the "Securities Act") and the Securities Exchange Act of 1934[4] (the "Exchange Act").[5] As part of this rulemaking, we adopted Regulation AB,[6] a new principles-based set of disclosure items forming the basis for disclosure with respect to ABS in both Securities Act registration statements and Exchange Act reports. Compliance with the revised rules was phased in; full compliance with the revised rules became effective January 1, 2006. One of the significant features of Regulation AB is Item 1105, which requires, to the extent material, static pool information to be provided in the prospectus included in registration statements for ABS offerings.[7] While the disclosure required by Item 1105 depends on factors such as the type of underlying asset and materiality, the information required to be disclosed can be extensive. For example, a registrant may be required to disclose multiple performance metrics in periodic

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2 17 CFR 232.10 et seq.

3 15 U.S.C. 77a et seq.

4 15 U.S.C. 78a et seq.

5 See Asset-Backed Securities, Release No. 33-8518 (December 22, 2004) [70 FR 1506] (adopting release related to Regulation AB and other new rules and forms related to asset-backed securities) (hereinafter, the "2004 Adopting Release").

6 17 CFR 229.1100 et seq.

7 See Form S-1 and Form S-3 under the Securities Act. Static pool information indicates how groups, or static pools, of assets, such as those originated at different intervals, are performing over time. By presenting comparisons between originations at similar points in the assets' lives, the data allows the detection of patterns that may not be evident from overall portfolio numbers and thus may reveal a more informative picture of material elements of portfolio performance and risk.

increments for prior securitized pools of the sponsor for the same asset type in the last five years.[8]

As described in the 2004 Adopting Release, in response to the Commission's proposal to require material static pool information in prospectuses for ABS offerings, many commenters representing both ABS issuers and investors requested flexibility in the presentation of such information. In particular, commenters noted that the required static pool information could include a significant amount of statistical information that would be difficult to file electronically on EDGAR as it existed at that time and difficult for investors to use in that format. Commenters accordingly requested the flexibility for ABS issuers to provide static pool information on an Internet Web site rather than as part of an EDGAR filing.[9] In response to these comments, we adopted Rule 312 of Regulation S-T, which permits, but does not require, the posting of the static pool information required by Item 1105 on an Internet Web site under the conditions set forth in the rule.[10] We recognized at the time that a Web-based approach might allow for the provision of the required information in a more efficient, dynamic and useful format than was currently feasible on the EDGAR system. At the same time, we explained that we continued to believe at some point for future transactions the information should also be submitted with the Commission in some fashion, provided investors continue to receive the information in the form they have requested. Accordingly, we adopted Rule 312 as a temporary filing accommodation applicable to filings filed on or before December 31,

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8 17 CFR 229.1105.

9 See 2004 Adopting Release, Section III.B.4.b.

10 17 CFR 232.312(a). Instead of relying on Rule 312, an issuer can include information required by Item 1105 of Regulation AB physically in the prospectus or, if permitted, through incorporation by reference from an Exchange Act report.

2009.[11] We explained that we were directing our staff to consult with the EDGAR contractor, EDGAR filing agents, issuers, investors and other market participants to consider how static pool information could be filed with the Commission in a cost-effective manner without undue burden or expense that still allows issuers to provide the information in a desirable format. We also noted, however, that it might be necessary, among other things, to extend the accommodation.[12]

In October 2009, we published for public comment[13] a proposed amendment to extend the temporary filing accommodation set forth in Rule 312 of Regulation S-T for one year so that it would apply to filings with respect to ABS filed on or before December 31, 2010.

We received three comment letters that addressed the proposed extension.[14] Two commenters expressed support for the Rule 312 filing accommodation and the proposed extension.[15] The ASF cited the strong preference among both its issuer and investor members for Web-based presentation of static pool information due to its efficiency, utility and effectiveness and the current lack of an adequate filing alternative.[16] The ABA Committees expressed their belief that the accommodation has been highly

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11 17 CFR 232.312(a); see also 2004 Adopting Release, Section III.B.4.b.

12 2004 Adopting Release, Section III.B.4.b.

13 Extension of Filing Accommodation for Static Pool Information in Filings With Respect to Asset-Backed Securities, Release No. 33-9074 (October 19, 2009) [74 FR 54767] (hereinafter, the "Proposing Release").

14 The public comments we received are available online at http://www.sec.gov/comments/s7-23-09/s72309.shtml.

15 See letters from the American Securitization Forum (the "ASF") and the Committee on Federal Regulation of Securities and the Committee on Securitization and Structured Finance of the Section of Business Law of the American Bar Association (the "ABA Committees").

16 See letter from ASF.

successful and of great value to investors.[17] Neither the ASF nor the ABA Committees was aware of any difficulties that investors or other market participants had locating, accessing, viewing or analyzing static pool information disclosed on a Web site.[18] For these reasons, among others, both the ASF and the ABA Committees requested that the filing accommodation be made permanent or, in the alternative, extended for a longer period of time.[19] One commenter, in contrast, did not support the extension and suggested the Commission should require structured disclosure using an industry standard computer language.[20]

We are adopting as proposed a one-year extension to the temporary filing accommodation provided by Rule 312. Based on the staff's experience since Rule 312 became effective in 2006, the vast majority of residential mortgage-backed security issuers and a significant portion of ABS issuers in other asset classes have relied on the accommodation provided by the rule to disclose static pool information on an Internet Web site. Furthermore, we believe that it remains the case that it could be difficult to file the information electronically on EDGAR as it exists today and difficult for investors to use in that format.

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17 See letter from ABA Committees.

18 See letters from ASF and ABA Committees.

19 Id. The ASF requested a five-year extension if the rule could not be made permanent and the ABA Committees requested an 18 to 24 month extension in such a case. Both the ASF and the ABA Committees expressed the belief that a permanent or longer extension would encourage continued use of the Web-based presentation by providing more of an incentive for issuers to make investments in developing and innovating Web sites for static pool disclosure. A longer extension would also, the ASF noted, give the Commission adequate time to consider alternatives.

20 See letter from Paul Wilkinson. If the alternate approach supported by Mr. Wilkinson could not be implemented by January 1, 2010, he recommended that any extension only last until the alternate approach could be implemented. As discussed more fully below, the staff of the Division of Corporation Finance is in the process of exploring the feasibility of a filing mechanism for static pool information that would allow the information to be filed with the Commission in an efficient and useful manner.

During the extension, the existing requirements of Rule 312 will continue to apply. Pursuant to these requirements, the registrant must disclose its intention to provide static pool information through a Web site in the prospectus included in the registration statement at the time of effectiveness and provide the specific Internet address where the static pool information is posted in the prospectus filed pursuant to Rule 424.[21] The registrant must maintain such information on the Web site unrestricted and free of charge for a period of not less than five years, indicate the date of any updates or changes to the information, undertake to provide any person without charge, upon request, a copy of the information as of the date of the prospectus if a subsequent update or change is made to the information and retain all versions of the information provided on the Web site for a period of not less than five years in a form that permits delivery to an investor or the Commission. In addition, the registration statement for the ABS must contain an undertaking pursuant to Item 512(l) of Regulation S-K[22] that the information provided on the Web site pursuant to Rule 312 is deemed to be part of the prospectus included in the registration statement.[23]

As we noted in the Proposing Release, since the adoption of Rule 312 in December, 2004, technological advances and expanded use of the Internet have enabled the Commission to adopt additional rules incorporating electronic communications. The Commission continues to recognize that, in certain circumstances and under certain

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21 17 CFR 230.424.

22 17 CFR 229.512(l).

23 17 CFR 232.312. As we indicated in the 2004 Adopting Release, if the conditions of Rule 312 are satisfied, then the information will be deemed to be part of the prospectus included in the registration statement and thus subject to all liability provisions applicable to prospectuses and registration statements, including Section 11 of the Securities Act [15 U.S.C. 77k]. 2004 Adopting Release, Section III.B.4.b.

conditions, the Internet can present a reliable and cost-effective alternative or supplement to traditional disclosure methods.[24] On the other hand, we are mindful of the benefit of having information filed on the EDGAR system.

As we noted in the Proposing Release, the staff of the Division of Corporation Finance is currently engaged in a broad review of the Commission's regulation of ABS including disclosure, offering process, and reporting of ABS issuers. Along with this review, the staff of the Division of Corporation Finance is continuing to explore whether a filing mechanism for static pool information that fulfills the objectives identified above is feasible. Although we note the two commenters' requests that we make the filing accommodation permanent or extend it for a longer period of time as well as the other commenter's request that we immediately move to provide for structured disclosure using an industry standard computer language, we continue to believe a proposal for a longer-term solution for providing static pool disclosure would be better considered together with other possible proposals to revise the regulations governing the offer and sale of ABS. The one-year extension of Rule 312 that we are adopting today is intended to provide time to enable us to proceed in this manner.

The Administrative Procedure Act generally requires that an agency publish an adopted rule in the Federal Register 30 days before it becomes effective. This requirement, however, does not apply if the agency finds good cause for making the rule

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24 See, e.g., Internet Availability of Proxy Materials, Release No. 34-55146 (Jan. 22, 2007) [72 FR 4148] (adopting release for voluntary E-Proxy rules) and Internet Availability of Proxy Materials, Release No. 34-52926 (December 8, 2005) [70 FR 74598] (proposing release for voluntary E-Proxy rules). See also Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Release No. 33-8998, Section III.A.4.c (Jan. 13, 2009) [74 FR 4546] (adopting Item 11(g)(2) of Form N-1A under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.] which allows exchange-traded funds to provide premium/discount information on a Web site rather than in a prospectus or annual report) and Securities Offering Reform, Release No. 33-8591, SectionVI.B.1 (July 19, 2005) [70 FR 44722] (adopting "access equals delivery" model for final prospectus delivery).

effective sooner.[25] Because the temporary filing accommodation expires on December 31, 2009, we believe it is necessary to make the amendment effective December 31st so that there is no gap between which an issuer would be required to convert its static pool data into an EDGAR filing. In addition, this extension creates no new requirements but maintains a voluntary accommodation that relieves a registrant from the obligation to file static pool data on EDGAR, provided it makes the information available on a Web site. The Commission therefore believes the extension grants or recognizes an exemption or relieves a restriction. On the basis of the foregoing, the Commission finds good cause to make the amendment effective December 31, 2009.

II. PAPERWORK REDUCTION ACT

Rule 312 of Regulation S-T was adopted in 2004 along with other new and amended rules and forms to address the registration, disclosure and reporting requirements for ABS under the Securities Act and the Exchange Act. In connection with this prior rulemaking, we submitted a request for approval of the "collection of information" requirements contained in the amendments and rules to the Office of Management and Budget ("OMB") in accordance with the Paperwork Reduction Act of 1995 ("PRA").[26] OMB approved these requirements.[27]

Item 1105 of Regulation AB[28] requires certain static pool information, to the extent material, to be provided in prospectuses included in registration statements for

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25 See 5 U.S.C. 553(d).

26 44 U.S.C. 3501 et seq.

27 The collections of information to which Rule 312 of Regulation S-T relates are "Form S-1" (OMB Control No. 3235-0065) and "Form S-3" (OMB Control No. 3235-0073).

28 17 CFR 229.1105.

ABS offerings.[29] Rule 312 is a temporary filing accommodation that permits the posting of the static pool information required by Item 1105 on an Internet Web site under the conditions set forth in the rule.[30] The amendment to Rule 312 extends the existing temporary filing accommodation provided by the rule for one additional year. As is the case today, issuers may choose whether or not to take advantage of the accommodation during the extension. The conditions of Rule 312 remain otherwise unchanged. The disclosure requirements themselves, which are contained in Forms S-1 and S-3 under the Securities Act and require the provision of the information set forth in Item 1105 of Regulation AB, also remain unchanged. Therefore, the amendment will not result in an increase or decrease in the costs and burdens imposed by the "collection of information" requirements previously approved by the OMB. No commenter suggested the extension would impose any new paperwork burden.

III. COST-BENEFIT ANALYSIS

In this section, we examine the benefits and costs of the amendment. In the Proposing Release, we requested that commenters provide views, supporting information and estimates on the benefits and costs that may result from the adoption of the proposed amendment. No commenter addressed the cost-benefit analysis of the Proposing Release.

A. Benefits

We initially adopted the filing accommodation provided by Rule 312 of Regulation S-T because commenters requested flexibility in the presentation of required static pool information.[31] Given the large amount of statistical information involved,

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29 See Form S-1 and Form S-3 under the Securities Act.

30 17 CFR 232.312(a).

31 See 2004 Adopting Release, Section III.B.4.b.

those commenters argued for a Web-based approach that would allow issuers to present the information in an efficient manner and with greater functionality and utility than might be available if an EDGAR filing was required.[32] We believe this greater functionality and utility has enhanced an investor's ability to access and analyze the static pool information and also removed the burden on issuers of duplicating the information in each prospectus as well as easing the burdens of updating such information.[33] As we discussed in the 2004 Adopting Release, since the information is deemed to be part of the prospectus included in the registration statement, the rule is designed to give investors access to accurate and reliable information.[34]

By extending the accommodation provided by Rule 312, these benefits to both issuers and investors will continue to apply. As discussed above, many ABS issuers rely on Rule 312 to provide static pool information on an Internet Web site rather than in an EDGAR filing.[35] We proposed the one-year extension of Rule 312 because we do not believe we can implement an alternative filing mechanism by the end of 2009 that would meet the objectives of both issuers and investors to present static pool information in an efficient, cost-effective form that would provide investors utility and functionality in terms of accessing and analyzing that information. Therefore, if we did not amend Rule 312 to extend its application as we are doing today, static pool information would have been required in EDGAR filings beginning on January 1, 2010. We believe this would have resulted in costs for issuers as they attempt to adjust their procedures in a short period of time in order to present the information in a format acceptable to the EDGAR

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32 Id.

33 See Section I above and 2004 Adopting Release, Section V.D.

34 See 2004 Adopting Release, Section III.B.4.b.

35 See Section I above.

system and could have resulted in costs to investors if the information filed on EDGAR was presented in a less useful format.

By extending Rule 312, we seek to avoid these potentially negative effects for issuers and investors as we continue to explore the best format in which to require the filing of static pool information. As indicated above, the staff of the Division of Corporation Finance is considering this issue along with other proposals addressing the disclosure, offering process and reporting of ABS issuers.

B. Costs

We do not believe the one-year extension of the Rule 312 accommodation will impose any new or increased costs on issuers. In the Cost-Benefit Analysis section of the 2004 Adopting Release, we noted that ABS issuers electing the Web-based accommodation provided by Rule 312 would incur costs related to the maintenance and retention of static pool information posted on a Web site and might also incur start-up costs.[36] While it is likely that certain of those costs will continue to impact ABS issuers that elect the Web-based approach during the extension period, we do not believe the amendment will impose any new or increased costs for ABS issuers because it does not change any other conditions to the accommodation or the underlying filing and disclosure obligations. As a result of the extension of the accommodation, ABS issuers will be able to continue their current practices for an additional year.

For investors, there may be costs associated with the static pool information not being electronically filed with the Commission. For example, when information is electronically filed with the Commission, investors and staff can access the information

36 See 2004 Adopting Release, Section V.D.

from a single, centralized location, the EDGAR Web site. We think these costs are mitigated by the fact that ABS issuers relying on the Rule 312 accommodation must ensure that the prospectus for the offering contains the Internet Web site address where the static pool information is posted, the Web site must be unrestricted and free of charge, such information must remain on the Internet Web site for five years with any changes clearly indicated and the issuer must undertake to provide the information to any person free of charge, upon request, if a subsequent update or change is made. Furthermore, because the information is deemed included in the prospectus under Rule 312, it is subject to all liability provisions applicable to prospectuses and registration statements.

Investors and issuers may have incurred costs to adjust their processes in anticipation of the lapse of the Rule 312 accommodation and potential reversion to a requirement to file static pool information on EDGAR. In this case, benefits to investors or issuers of not having to change their procedures regarding static pool reporting in a short time frame would be diminished by any costs already incurred in anticipation of the change. We believe such anticipatory action and any associated costs are minimal.

IV. CONSIDERATION OF IMPACT ON THE ECONOMY, BURDEN ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 2(b) of the Securities Act requires us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to also consider whether the action will promote efficiency, competition, and capital formation.

As discussed in greater detail above, Rule 312 of Regulation S-T was adopted as a temporary filing accommodation so that issuers of ABS could present static pool information on an Internet Web site. The amendment to Rule 312 of Regulation S-T that we are adopting today extends its application for one year. We are not changing the conditions of Rule 312 or the disclosure obligations to which it applies. We do not believe that the one-year extension will impose a burden on competition. We also believe the extension of the filing accommodation will continue to promote efficiency and capital formation by permitting ABS issuers to disclose static pool information in a format that is more useful to investors and cost-effective and not unduly burdensome for ABS issuers.

We requested comment on whether the proposed amendment, if adopted, would promote efficiency, competition, and capital formation. We did not receive any comments directly responding to this request.

V. REGULATORY FLEXIBILITY ANALYSIS CERTIFICATION

In Part VI of the Proposing Release, the Commission certified pursuant to Section 605(b) of the Regulatory Flexibility Act[37] that the proposed amendment to Rule 312 of Regulation S-T would not have a significant economic impact on a substantial number of small entities. While the Commission encouraged written comments regarding this certification, no commenters responded to this request or indicated that the amendment as adopted would have a significant economic impact on a substantial number of small entities.

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[37] 5 U.S.C. 605(b).

VI. STATUTORY AUTHORITY AND TEXT OF THE FINAL AMENDMENT

The amendment described is being adopted under the authority set forth in Sections 6, 7, 10, 19 and 28 of the Securities Act of 1933 (15 U.S.C. 77f, 77g, 77j, 77s and 77z-3).

List of Subjects

17 CFR Part 232

Reporting and recordkeeping requirements, Securities.

TEXT OF THE AMENDMENT

For the reasons set out in the preamble, the Commission hereby amends title 17, chapter II, of the Code of Federal Regulations as follows:

PART 232 – REGULATION S-T – GENERAL RULES AND REGULATIONS FOR ELECTRONIC FILINGS

1. The authority citation for part 232 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a), 77z–3, 77sss(a), 78c(b), 78l, 78m, 78n, 78o(d), 78w(a), 78ll, 80a–6(c), 80a–8, 80a–29, 80a–30, 80a–37, and 7201 et seq.; and 18 U.S.C. 1350.

* * * * *

2. Amend §232.312 by removing "December 31, 2009" and in its place adding "December 31, 2010" in the first sentence of paragraph (a).

* * * * *

By the Commission.

Elizabeth M. Murphy
Secretary

December 15, 2009

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 229, 239, 240, 249 and 274

[RELEASE NOS. 33-9089; 34-61175; IC-29092; File No. S7-13-09]

RIN 3235-AK28

PROXY DISCLOSURE ENHANCEMENTS

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: We are adopting amendments to our rules that will enhance information provided in connection with proxy solicitations and in other reports filed with the Commission. The amendments will require registrants to make new or revised disclosures about: compensation policies and practices that present material risks to the company; stock and option awards of executives and directors; director and nominee qualifications and legal proceedings; board leadership structure; the board's role in risk oversight; and potential conflicts of interest of compensation consultants that advise companies and their boards of directors. The amendments to our disclosure rules will be applicable to proxy and information statements, annual reports and registration statements under the Securities Exchange Act of 1934, and registration statements under the Securities Act of 1933 as well as the Investment Company Act of 1940. We are also transferring from Forms 10-Q and 10-K to Form 8-K the requirement to disclose shareholder voting results.

EFFECTIVE DATE: February 28, 2010

FOR FURTHER INFORMATION CONTACT: N. Sean Harrison, Special Counsel, at (202) 551-3430 or Anne Krauskopf, Senior Special Counsel, at (202) 551-3500, in the Division of Corporation Finance; or with respect to questions regarding investment companies, Alberto

Zapata, Senior Counsel, Division of Investment Management, at (202) 551-6784, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are adopting amendments to Items 401,[1] 402,[2] and 407[3] of Regulation S-K;[4] Schedule 14A[5] and Forms 8-K,[6] 10-Q,[7] and 10-K[8] under the Securities Exchange Act of 1934 ("Exchange Act");[9] and Forms N-1A,[10] N-2,[11] and N-3,[12] registration forms used by management investment companies to register under the Investment Company Act of 1940 ("Investment Company Act")[13] and to offer their securities under the Securities Act of 1933 ("Securities Act").[14]

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[1] 17 CFR 229.401.

[2] 17 CFR 229.402.

[3] 17 CFR 229.407.

[4] 17 CFR 229.10 et al.

[5] 17 CFR 240.14a-101.

[6] 17 CFR 249.308.

[7] 17 CFR 249.308a.

[8] 17 CFR 249.310.

[9] 15 U.S.C. 78a et seq.

[10] 17 CFR 239.15A and 274.11A.

[11] 17 CFR 239.14 and 274.11a-1.

[12] 17 CFR 239.17a and 274.11b.

[13] 15 U.S.C. 80a-1 et seq.

[14] 15 U.S.C. 77a et seq.

A. Enhanced Compensation Disclosure

1. Narrative Disclosure of the Company's Compensation Policies and Practices as They Relate to the Company's Risk Management

   a. Proposed Amendments

   b. Comments on the Proposed Amendments

   c. Final Rule

2. Revisions to the Summary Compensation Table

   a. Proposed Amendments

   b. Comments on the Proposed Amendments

   c. Final Rule

   d. Transition

   e. Comment Responses Regarding Rulemaking Petition and Other Requests for Comment

B. Enhanced Director and Nominee Disclosure

1. Proposed Amendments

2. Comments on the Proposed Amendments

3. Final Rule

C. New Disclosure about Board Leadership Structure and the Board's Role in Risk Oversight

1. Proposed Amendments

2. Comments on the Proposed Amendments

3. Final Rule

D. New Disclosure Regarding Compensation Consultants

1. Proposed Amendments

2. Comments on the Proposed Amendments

I. BACKGROUND AND OVERVIEW OF THE AMENDMENTS

On July 10, 2009, we proposed a number of revisions to our rules that were designed to improve the disclosure shareholders of public companies receive regarding compensation and corporate governance.[15] As discussed in detail below, we have taken into consideration the comments received on the proposed amendments and are adopting several amendments to our rules. Among other improvements, the new disclosure requirements adopted today enhance the information provided in annual reports, and proxy and information statements to better enable shareholders to evaluate the leadership of public companies.

As discussed more fully in the Proposing Release, during the past few years, investors have increasingly focused on corporate accountability and have expressed the desire for additional information that would enhance their ability to make informed voting and investment decisions. The disclosure enhancements we are adopting respond to this focus, and will

[15] See Release No. 33-9052 (July 10, 2009) [74 FR 35076] ("Proposing Release").

significantly improve the information companies provide to shareholders with regard to the following:

- Risk: by requiring disclosure about the board's role in risk oversight and, to the extent that risks arising from a company's compensation policies and practices are reasonably likely to have a material adverse effect on the company, disclosure about such policies and practices as they relate to risk management;
- Governance and Director Qualifications: by requiring expanded disclosure of the background and qualifications of directors and director nominees and new disclosure about a company's board leadership structure, and accelerating the reporting of information regarding voting results; and
- Compensation: by revising the reporting of stock and option awards in the Summary Compensation Table[16] and Director Compensation Table,[17] and requiring disclosure of potential conflicts of interest of compensation consultants in certain circumstances.

We believe that providing a more transparent view of these key risk, governance and compensation matters will help shareholders make more informed voting and investment decisions.

We received over 130 comment letters in response to the proposed amendments.[18] These letters came from corporations, pension funds, professional associations, trade unions, accounting firms, law firms, consultants, academics, individual investors and other interested parties. In general, the commenters supported the objectives of the proposed new requirements.

[16] Item 402(c) and 402(n) of Regulation S-K [17 CFR 229.402(c) and 229.402(n)].

[17] Item 402(k) and 402(r) of Regulation S-K [17 CFR 229.402(k) and 229.402(r)].

[18] The public comments we received are available on our Web site at http://www.sec.gov/comments/s7-13-09/s71309.shtml. Comments are also available for Web site viewing 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.

Most investors supported the manner in which we proposed to achieve these objectives and, in some cases, urged us to require additional disclosure from companies. Other commenters, however, opposed some of the proposed revisions and suggested modifications to the proposals.

We have reviewed and considered all of the comments that we received on the proposed amendments. The adopted rules reflect changes made in response to many of these comments. We discuss our revisions with respect to each proposed rule amendment in more detail throughout this release. The amendments that we are adopting will require:

- To the extent that risks arising from a company's compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company, discussion of the company's compensation policies or practices as they relate to risk management and risk-taking incentives that can affect the company's risk and management of that risk;
- Reporting of the aggregate grant date fair value of stock awards and option awards granted in the fiscal year in the Summary Compensation Table and Director Compensation Table to be computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718, Compensation—Stock Compensation ("FASB ASC Topic 718"),[19] rather than the dollar amount recognized for financial statement purposes for the fiscal year, with a special instruction for awards subject to performance conditions;

[19] Both our rule proposal and the former disclosure requirement used the nomenclature Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004) Share-Based Payment (FAS 123R). We are updating our references in this release and the final rules to reflect that the FASB Accounting Standards Codification has superseded all references to previous FASB standards for interim or annual periods ending on or after September 15, 2009.

- New disclosure of the qualifications of directors and nominees for director, and the reasons why that person should serve as a director of the company at the time at which the relevant filing is made with the Commission; the same information would be required in the proxy materials prepared with respect to nominees for director nominated by others;
- Additional disclosure of any directorships held by each director and nominee at any time during the past five years at any public company or registered investment company;
- New disclosure regarding the consideration of diversity in the process by which candidates for director are considered for nomination by a company's nominating committee;
- Additional disclosure of other legal actions involving a company's executive officers, directors, and nominees for director, and lengthening the time during which such disclosure is required from five to ten years;
- New disclosure about a company's board leadership structure and the board's role in the oversight of risk;
- New disclosure about the fees paid to compensation consultants and their affiliates under certain circumstances; and
- Disclosure of the vote results from a meeting of shareholders on Form 8-K generally within four business days of the meeting.

With respect to management investment companies that are registered under the Investment Company Act ("funds"),[20] the amendments we are adopting will require expanded

[20] Management investment companies typically issue shares representing an interest in a changing pool of securities, and include open-end and closed-end companies. An open-end company is a management company that is offering

disclosure regarding director and nominee qualifications; past directorships held by directors and nominees; and legal proceedings involving directors, nominees, and executive officers to funds; and new disclosure about leadership structure and the board's role in the oversight of risk.

The Proposing Release also included several proposed amendments to our rules governing the proxy solicitation process. We have decided to defer consideration of those proposed amendments at this time, pending our consideration of our proposal intended to facilitate shareholder director nominations in companies' proxy materials.[21]

II. DISCUSSION OF THE AMENDMENTS

A. Enhanced Compensation Disclosure

1. Narrative Disclosure of the Company's Compensation Policies and Practices as They Relate to the Company's Risk Management

We proposed amendments to our Compensation Discussion and Analysis ("CD&A") requirements to broaden their scope to include a new section regarding how the company's overall compensation policies for employees create incentives that can affect the company's risk and management of that risk. We are adopting the disclosure requirements generally as proposed, but we are revising the placement of the new required disclosures and the disclosure threshold, as suggested by commenters.

a. Proposed Amendments

Under the amendments we proposed, companies would be required to discuss and analyze their broader compensation policies and overall actual compensation practices for employees generally, including non-executive officers, if risks arising from those compensation

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for sale or has outstanding any redeemable securities of which it is the issuer. A closed-end company is any management company other than an open-end company. See Section 5 of the Investment Company Act [15 U.S.C. 80a-5].

[21] See Release No. 33-9046 (June 10, 2009) [74 FR 29024].

policies or practices may have a material effect on the company. As we stated in the Proposing Release, we believe that disclosure of a company's compensation policies and practices in certain circumstances can help investors identify whether the company has established a system of incentives that can lead to excessive or inappropriate risk taking by employees.

The proposed amendments enumerated a non-exclusive list of situations where compensation programs may raise material risks to companies, and several examples of the types of issues that would be appropriate for a company to discuss and analyze. The illustrative examples, consistent with the principles-based approach of the CD&A, were intended to help identify the types of situations in which the disclosure may be required.

b. Comments on the Proposed Amendments

Comments on the proposal were mixed. Individual investors, trade unions, institutional investors and pension funds supported the proposals.[22] Some of these commenters believed the new CD&A disclosure would improve the ability of investors to make informed investment decisions.[23] Other commenters believed the amendments would significantly improve shareholders' understanding of both the process by which pay is set and the substantive policies that guide companies' risk assessment or incentive considerations in structuring compensation policies or awarding compensation.[24]

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[22] See, e.g., letters from American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), American Association of Retired Persons ("AARP"), Grahall Partners LLC, Institute of Internal Auditors ("IIA"), Pfizer Inc., Risk and Insurance Management Society, Inc. ("RIMS"), State of Connecticut Treasurer's Office ("CTO"), State of Wisconsin Investment Board ("SWIB"), Ralph S. Saul, Teachers Insurance and Annuity Association of America - College Retirement and Equities Fund ("TIAA-CREF"), and Mark Whitton.

[23] See, e.g., letters from California State Teachers' Retirement System ("CalSTRS"), and RIMS.

[24] See, e.g., letters from Service Employees International Union ("SEIU"), and Walden Asset Management.

Most companies, law firms and bar groups opposed the proposal.[25] Concerns that were expressed included, for example, that the proposed amendments would not lead to meaningful disclosures,[26] and that the CD&A was already long and the proposed amendments would add length without a corresponding benefit to shareholders.[27] Another concern expressed by commenters was that the linkage between risk-taking and executive compensation is not well understood, and that the disclosures provided under the proposed amendments would likely be boilerplate that could give investors a false sense of comfort regarding risk and risk-taking.[28]

Other commenters argued that it was not appropriate to expand the CD&A beyond the named executive officers to include disclosure of the company's broader compensation policies and overall compensation practices for employees generally.[29] Some of these commenters argued that expanding the CD&A would represent a fundamental shift in the approach to the CD&A.[30] Concerns were also expressed that risk management, risk-taking incentives and related business strategy are complex subjects that could not be adequately analyzed in CD&A without adding voluminous text to an already lengthy proxy statement.[31]

Comments also were mixed on the illustrative examples included with the proposed amendments. Some commenters supported the list, noting that the additional disclosures would

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[25] See, e.g., letters from the American Bar Association ("ABA"), Robert Ahrenholz, American Electric Power, Business Roundtable, StanCorp Financial Group, and Wisconsin Electric Corporation.

[26] See, e.g., letters from Association Corporate Counsel ("ACC"), BorgWarner Inc., NACCO Industries, Inc. ("NACCO"), and Sullivan & Cromwell ("S&C").

[27] See, e.g., letters from National Association of Corporate Directors ("NACD") and S&C.

[28] See, e.g., letters from ABA and DolmatConnell Partners, Inc. ("DolmatConnell").

[29] See, e.g., letters from BorgWarner, NACCO and the Society of Corporate Secretaries and Corporate Governance Professionals ("SCSGP").

[30] See, e.g., letters from BorgWarner and NACCO.

[31] See e.g., letter of NACD.

provide investors with a better understanding of a company's compensation policies and how such policies can create incentives that could affect the company's risk profile and ability to manage that risk.[32] Other commenters asserted that the proposed revisions would lead to boilerplate disclosures and information that would not be meaningful to investors.[33]

Several commenters recommended that we revise the disclosure threshold in the proposed amendments, which we proposed as "may have a material effect" on the company.[34] Suggested alternatives included changing the standard to "likely to have a material effect," "reasonably likely to have a material effect," or "will likely have a material effect."[35] Some commenters believed the "may have a material effect" standard was too speculative and that basing the disclosure standard on whether the risks are "reasonably likely to have a material effect" would give companies more certainty and provide investors with more meaningful disclosure.[36] Commenters also noted that, to avoid voluminous and extraneous disclosure, the requirement should focus on compensation arrangements that are likely to promote risk-taking behavior that could have a significant and damaging impact on the company's operations.[37]

c. **Final Rule**

After considering the comments, we are adopting the disclosure requirement substantially as proposed with some modifications. We continue to believe that it is important for investors to

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[32] See, e.g., letters from CalSTRS, Council of Institutional Investors ("CII"), Glass Lewis & Co ("Glass Lewis"), and RIMS.

[33] See e.g., letters of Business Roundtable and Cleary Gottlieb Steen & Hamilton LLP ("Cleary Gottlieb").

[34] See letters from ACC, BorgWarner, Davis Polk & Wardwell LLP ("Davis Polk"), Honeywell International Inc. ("Honeywell"), NACCO, and SCSGP.

[35] See letters from ABA, ACC, BorgWarner, Davis Polk, Honeywell, NACCO, and SCSGP.

[36] See letters from ABA and Davis Polk.

[37] See letters from ABA and Pearl Meyer & Partners ("Pearl Meyer").

be informed of the compensation policies and practices that are likely to expose the company to material risk, but we recognize that, consistent with the comments received, we should revise our proposals. We have tailored the final amendments to address many of the concerns expressed by commenters, consistent with the purposes to be advanced by the disclosure.

The final rule requires a company to address its compensation policies and practices for all employees, including non-executive officers, if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company.[38] As noted above, the proposed rules would have required discussion and analysis of compensation policies if risks arising from those compensation policies "may have a material effect on the company." We agree with the suggestions of several commenters that the new requirements should have a "reasonably likely" disclosure threshold. Companies are familiar with the "reasonably likely" disclosure threshold used in our Management Discussion and Analysis ("MD&A") rules,[39] and this approach would parallel the MD&A requirement, which requires risk-oriented disclosure of known trends and uncertainties that are material to the business. We believe that the "reasonably likely" threshold also addresses concerns of some commenters that the proposed requirements might have caused companies attempting compliance to burden shareholders and investors with voluminous disclosure of potentially insignificant and unnecessarily speculative information about their compensation policies. By focusing on risks that are "reasonably likely to have a material adverse effect" on the company, the amendments are intended to elicit disclosure about incentives in the company's compensation policies and practices that would be most relevant to

[38] See new Item 402(s) of Regulation S-K. As we noted in the Proposing Release, to the extent that risk considerations are a material aspect of the company's compensation policies or decisions for named executive officers, the company is required to discuss them as part of its CD&A under the current rules.

[39] See Item 303 of Regulation S-K [17 CFR 229.303].

investors.[40] This change from the proposal also addresses concerns some commenters raised that the proposal did not allow companies to consider compensating or offsetting steps or controls designed to limit risks of certain compensation arrangements.[41] If a company has compensation policies and practices for different groups that mitigate or balance incentives, these could be considered in deciding whether risks arising from the company's compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company as a whole.

In addition, we have modified the proposal to provide that disclosure is only required if the compensation policies and practices are reasonably likely to have a material "adverse" effect on the company, as opposed to any "material effect" as proposed. As noted in the Proposing Release, well-designed compensation policies can enhance a company's business interests by encouraging innovation and appropriate levels of risk-taking. By focusing the disclosure on material adverse effects, the final rule should help avoid voluminous and unnecessary discussion of compensation arrangements that may mitigate inappropriate risk-taking incentives..

We are also moving the new requirements into a separate paragraph in Item 402 of Regulation S-K.[42] As adopted, the new disclosure requirements will not be a part of the CD&A.[43] We were persuaded by commenters who asserted that it would be potentially confusing to expand the CD&A beyond the named executive officers to include disclosure of the company's

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[40] See note 36 above and accompanying text.

[41] See letters from ABA and Center on Executive Compensation.

[42] See new Item 402(s) of Regulation S-K.

[43] In making this change, we also revised the final rule from what was proposed by eliminating the term "generally." Previously, we believed this term was helpful to distinguish the proposed amendments from the CD&A for the named executive officers by emphasizing that it also applied to non-executive officers. Because we are moving the new requirements into a separate paragraph, we do not believe the term is needed. Moreover, one commenter noted that the term could be confusing in light of the examples listed in the rule. See letter from ABA.

broader compensation policies and practices for employees. CD&A provides discussion and analysis of the compensation of the named executive officers and the information contained in the Summary Compensation Table and other required tables, and the new disclosure requirements would be inconsistent with that approach because they would cover all employees, not just the named executive officers.[44]

The final rule will contain, as proposed, the non-exclusive list of situations where compensation programs may have the potential to raise material risks to companies, and the examples of the types of issues that would be appropriate for a company to address. Under the amendments, the situations that would require disclosure will vary depending on the particular company and its compensation program. We believe situations that potentially could trigger discussion include, among others, compensation policies and practices:

- At a business unit of the company that carries a significant portion of the company's risk profile;
- At a business unit with compensation structured significantly differently than other units within the company;
- At a business unit that is significantly more profitable than others within the company;
- At a business unit where the compensation expense is a significant percentage of the unit's revenues; and
- That vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

[44] See letters from BorgWarner, NACCO and SCSGP.

This is a non-exclusive list of situations where compensation programs may have the potential to raise material risks to the company. There may be other features of a company's compensation policies and practices that have the potential to incentivize its employees to create risks that are reasonably likely to have a material adverse effect on the company. However, disclosure under the amendments is only required if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. We note that in the situations listed above, a company may under appropriate circumstances conclude that its compensation policies and practices are not reasonably likely to have a material adverse effect on the company.

We are adopting, as proposed, the illustrative examples of the issues that would potentially be appropriate for a company to address. As we stated in the Proposing Release, the examples are non-exclusive and that the application of an example should be tailored to the facts and circumstances of the company. We believe that a principles-based approach, similar to our CD&A requirements, utilizing illustrative examples strikes an appropriate balance that will effectively elicit meaningful disclosure. If a company determines that disclosure is required, we believe examples of the issues that companies may need to address regarding their compensation policies or practices include the following:

- The general design philosophy of the company's compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices, as such policies and practices relate to or affect risk taking by those employees on behalf of the company, and the manner of their implementation;
- The company's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation;

- How the company's compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring claw backs or imposing holding periods;
- The company's policies regarding adjustments to its compensation policies and practices to address changes in its risk profile;
- Material adjustments the company has made to its compensation policies and practices as a result of changes in its risk profile; and
- The extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees.

We believe using illustrative examples helps to identify the types of disclosure that may be applicable. However, companies must assess the information that is identified by the example in light of the company's particular situation. Thus, for example, we would not expect to see generic or boilerplate disclosure that the incentives are designed to have a positive effect, or that compensation levels may not be sufficient to attract or retain employees with appropriate skills in order to enable the company to maintain or expand operations.

Consistent with the approach taken in the proposals, smaller reporting companies will not be required to provide the new disclosure, even though the new rule will not be part of CD&A.[45] At this time, we believe that such companies are less likely to have the types of compensation policies and practices that are intended to be addressed in this rulemaking.[46]

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[45] Because smaller reporting companies are not required to provide CD&A disclosure, we did not propose to require that they provide the new disclosure.

[46] See, e.g., letter of Committee on Securities Law of the Business Law Section of the Maryland State Bar Association ("In our view smaller reporting companies and their compensation structures generally are not geared towards the kind of disclosure that would be required by the proposal"). The amendments will not alter the reporting requirements for smaller reporting companies under Item 402. Specifically, smaller reporting companies are

In the Proposing Release, we requested comment on whether we should require a company to affirmatively state that it has determined that the risks arising from its compensation policies are not reasonably expected to have a material effect on the company if it has concluded that disclosure was not required. Commenters were mixed in their response to this request. Several commenters believed that companies should be required to affirmatively state that they have determined that the risks arising from their broader compensation policies are not reasonably expected to have a material effect.[47] Others believed that the proposed amendments should not require an affirmative statement because it would not provide investors with useful information and would create potential liability for companies.[48] Another commenter noted that our disclosure rules have not traditionally required companies to address affirmatively matters that the company has determined are not applicable to it.[49] We believe an approach consistent with our prior practice is appropriate and the final rule does not require a company to make an affirmative statement that it has determined that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company.

2. Revisions to the Summary Compensation Table

We proposed to amend Item 402 of Regulation S-K to revise Summary Compensation Table and Director Compensation Table disclosure of stock awards and option awards to require disclosure of the aggregate grant date fair value of awards computed in accordance with FASB

permitted to provide the scaled disclosures specified in Items 402(l) through (r) of Regulation S-K, rather than the disclosure specified in Items 402(a) through (k) of Regulation S-K.

[47] See, e.g., letters from Calvert Group, Ltd. ("Calvert"), Grahall Partners and Integrated Governance Solutions.

[48] See, e.g., letters from the Business Roundtable, Honeywell, Pfizer and S&C.

[49] See letter from ABA.

ASC Topic 718. The revised disclosure[50] would replace previously mandated disclosure of the dollar amount recognized for financial statement reporting purposes for the fiscal year in accordance with FASB ASC Topic 718, and would affect the calculation of total compensation, including for purposes of determining who is a named executive officer.[51] We are adopting the revisions substantially as proposed with some changes in response to comments.

a. Proposed Amendments

As we stated in the Proposing Release, we proposed these amendments because of comments we previously received from a variety of sources that the information that investors would find most useful and informative in the Summary Compensation Table and Director Compensation Table is the full grant date fair value of equity awards made during the covered fiscal year. Investors may consider compensation decisions made during the fiscal year, which usually are reflected in the full grant date fair value measure but not in the financial statement recognition measure, to be material to voting and investment decisions.

We also proposed to rescind the requirement to report the full grant date fair value of each individual equity award in the Grants of Plan-Based Awards Table[52] and the corresponding footnote disclosure to the Director Compensation Table[53] because these disclosures may be considered duplicative of the aggregate grant date fair value to be provided in the amended Summary Compensation Table. In addition, we proposed to amend Instruction 2 to the salary and bonus columns of the Summary Compensation Table so that companies would not be

[50] Items 402(c)(2)(v) and (vi), 402(k)(2)(iii) and (iv), 402(n)(2)(v) and (vi), and 402(r)(2)(iii) and (iv) of Regulation S-K.

[51] Items 402(a)(3)(iii) and (iv) and 402(m)(2)(ii) and (iii) of Regulation S-K.

[52] Item 402(d)(2)(viii) of Regulation S-K and Instruction 7 to Item 402(d).

[53] Instruction to Item 402(k)(2)(iii) and (iv) of Regulation S-K.

required to report in those columns the amount of salary or bonus forgone at a named executive officer's election, and the non-cash awards received instead of salary or bonus would be reported in the column applicable to the form of award elected. As proposed, the Summary Compensation Table disclosure would reflect the form of compensation ultimately received by the named executive officer.

b. Comments on the Proposed Amendments

A broad spectrum of commenters supported the proposal to revise the Summary Compensation Table and Director Compensation Table disclosure of stock awards and option awards to require disclosure of the aggregate grant date fair value of awards.[54] Most commenters agreed that because aggregate grant date fair value disclosure better reflects compensation committee decisions with respect to stock and option awards,[55] it is more informative to voting and investment decisions[56] and a better measure for purposes of identifying named executive officers.[57] However, some commenters objected that use of grant date fair value to identify named executive officers may result in relatively frequent changes in the named executive

[54] See, e.g., letters from AARP, Business Roundtable, State of Wisconsin Investment Board ("SWIB"), Pfizer, SCSGP, S&C, United Brotherhood of Carpenters and Joiners of America ("United Brotherhood of Carpenters"), United States Proxy Exchange ("USPX").

[55] See, e.g., letters from Business Roundtable ("Generally, we support the Proposed Rules, as they likely will produce disclosure that, in most situations, is more in line with how compensation committees view annual equity compensation – that is, disclosure of the equity compensation that a company grants in a particular year."); and SCSGP ("We support this change. The aggregate grant date fair value is generally used by compensation committees in determining the amount of stock and options to award, whereas the current disclosure requirement confusingly focuses on accounting considerations that may have no bearing on compensation decisions.").

[56] See, e.g., letter of United Brotherhood of Carpenters ("The proposed SCT reporting of equity awards will help inform investment decisions, as well as important investor voting decisions regarding executive compensation and director performance.").

[57] See, e.g., letter of Mercer ("Because the value included in the SCT determines the identification of at least three of the named executive officers (other than the principal executive officer and the principal financial officer), disclosure of the full grant-date fair value would also better align the identification of these officers with company compensation decisions.").

officer group based on grants of "one time" multi-year awards to newly hired executives or special awards to enhance retention.[58]

As discussed in detail below, many commenters expressed concern that the amount to be reported in the table for performance awards would be calculated without regard to the likelihood of achieving the relevant performance objectives, which could discourage companies from granting these awards.[59] Others, however, suggested that the design of equity awards is driven by numerous considerations, and companies would continue to make equity awards subject to performance conditions.[60]

With respect to the proposal to rescind the requirement to report the full grant date fair value of each individual equity award in the Grants of Plan-Based Awards Table, the comments were mixed. While some commenters supported this proposal,[61] others stated that retaining disclosure of the grant date fair value of individual awards would continue to provide investors valuable information. Because different companies may vary in the assumptions they apply to compute grant date fair value, some commenters noted that retaining this disclosure makes it easier for investors to assess how companies determined fair value for individual grants.[62] Further, different types of equity awards can have different incentive effects, making it important that shareholders understand the value associated with each type of award granted and the mix of

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[58] See, e.g., letter of Protective Life Corporation.

[59] See, e.g., letters from ABA, Business Roundtable, Center on Executive Compensation, Cleary Gottlieb, Compensia, Honeywell, Frederic W. Cook & Co., Inc., Pearl Meyer, Protective Life Corporation, Securities Industry and Financial Markets Association (SIFMA), SCSGP, and Towers Perrin.

[60] See, e.g., letter from Hewitt Associates LLC ("Hewitt").

[61] See letters from Buck Consultants, Chadbourne Park, Mercer, Pfizer, Protective Life Corporation, and S&C.

[62] See letters from AFL-CIO, Compensia and Graef Crystal.

values among various award types.[63] Commenters pointed out that reporting the separate value of multiple individual awards provides investors more information regarding the specific decisions of the compensation committee, so that investors can better evaluate those decisions and understand pay for performance.[64]

We also received a wide range of comments on our proposal to amend Instruction 2 to the salary and bonus columns of the Summary Compensation Table. Some commenters favored this amendment because, as stated in the Proposing Release, it would report compensation in the form actually received.[65] Other commenters, however, said it is important to report the form of compensation that the compensation committee originally awarded, so that investors can understand the overall compensation strategy and the intended distribution of risk among different types of compensation.[66]

c. **Final Rule**

After considering the comments received, we are adopting the proposed amendments to revise Summary Compensation Table and Director Compensation Table disclosure of stock awards and option awards to require disclosure of the aggregate grant date fair value of awards computed in accordance with FASB ASC Topic 718, with a special instruction for awards subject to performance conditions as described below. We agree with commenters that aggregate grant date fair value disclosure better reflects the compensation committee's decision with regard to stock and option awards. We remain of the view that it is more meaningful to

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[63] See letters from Compensia, Frederic W. Cook & Co., Inc., and Risk Metrics.

[64] See letters from Center on Executive Compensation, Hewitt, Pearl Meyer, Towers Perrin, and Universities Superannuation Scheme, et al.

[65] See, e.g., letters from Pfizer and RiskMetrics.

[66] See letters from Center on Executive Compensation, and Pearl Meyer.

shareholders if company compensation decisions–including decisions to grant large "one time" multi-year awards–cause the named executive officers to change. In circumstances where such a large "new hire" or "retention" grant results in the omission from the Summary Compensation Table of another executive officer whose compensation otherwise would have been subject to reporting, the company can consider including compensation disclosure for that executive officer to supplement the required disclosures.

Based on comments received, we are clarifying how performance awards[67] are disclosed. Most commenters stated that reporting the aggregate grant date fair value of performance awards based on maximum performance could discourage companies from granting these awards.[68] Noting that compensation committees take performance-contingent conditions into account when granting such awards, commenters said that the grant date fair value reported for awards with a performance condition should instead be based on the probable outcome of the performance conditions, consistent with the recognition criteria in the accounting literature.[69] As commenters stated, because performance awards generally are designed to incentivize attainment of target performance and set a higher maximum performance level as a "cap" on attainable compensation, requiring disclosure of an award's value to always be based on maximum performance would overstate the intended level of compensation and result in investor misinterpretation of compensation decisions. This could also discourage the grant of awards

[67] Performance awards include only those awards that are subject to performance conditions as defined in the Glossary to FASB ASC Topic 718.

[68] See, e.g., letters from ABA, Business Roundtable, Center on Executive Compensation, Cleary Gottlieb, Compensia, Honeywell, Frederic W. Cook & Co., Inc., Pearl Meyer, Protective Life Corporation, SIFMA, SCSGP, and Towers Perrin.

[69] FASB ASC Topic 718.

with difficult – or any – performance conditions, and lead to inflated benchmarking values used to set equity award or total compensation levels at other companies.

We are persuaded that the value of performance awards reported in the Summary Compensation Table, Grants of Plan-Based Awards Table and Director Compensation Table should be computed based upon the probable outcome of the performance condition(s) as of the grant date because that value better reflects how compensation committees take performance-contingent vesting conditions into account in granting such awards. We are adopting new Instructions to these tables to clarify that this amount will be consistent with the grant date estimate of compensation cost to be recognized over the service period, excluding the effect of forfeitures.[70] To provide investors additional information about an award's potential maximum value subject to changes in performance outcome, we will also require in the Summary Compensation Table and Director Compensation Table footnote disclosure of the maximum value assuming the highest level of performance conditions is probable.[71] Such footnote disclosure will permit investors to understand an award's maximum value without raising the concerns associated with requiring its tabular disclosure.[72]

We are requiring disclosure of awards granted during the year, as proposed. A number of commenters responded to our request for comment by indicating that they would prefer disclosure of the aggregate grant date fair value of equity awards granted <u>for</u> services in the relevant fiscal year, even if granted after fiscal year end, rather than awards granted <u>during</u> the

[70] <u>See</u> Instruction 3 to Item 402(c)(2)(v) and (vi), Instruction 8 to Item 402(d), and Instruction 3 to Item 402(n)(2)(v) and (vi).

[71] <u>See</u> Instruction 3 to Item 402(c)(2)(v) and (vi), and Instruction 3 to Item 402(n)(2)(v) and (vi).

[72] <u>See</u>, <u>e.g.</u>, letter from ABA.

relevant fiscal year, as proposed.[73] Other commenters expressed concern that revising the proposal in this way would result in a lack of uniformity that would confuse investors, would be inconsistent with the FASB ASC Topic 718 grant date, and could invite manipulated reporting.[74] We recognize that a "performance year" standard for reporting equity awards in securities in the relevant fiscal year may sometimes better align compensation disclosure with compensation decision making, and may be more consistent with Summary Compensation Table salary and bonus disclosure.[75] However, because it appears that multiple subjective factors, which could vary significantly from company to company, influence equity awards granted after fiscal year end, we are concerned that changing the approach to reporting could result in inconsistencies that would erode comparability. One commenter noted that many companies make equity awards after the end of the fiscal year based on executive performance during the last completed fiscal year, but determining whether an equity award was granted primarily for services performed during the last completed fiscal year can be a highly subjective determination and the factors that influence the decision of when to report an equity award may vary significantly from company to company.[76] Companies should continue to analyze in CD&A their decisions to grant post-fiscal year end equity awards where those decisions could affect a fair understanding of named

[73] See, e.g., letters from ACC, Ameriprise Financial, Inc., BorgWarner, Business Roundtable, Cleary Gottlieb, Committee on Securities Law of the Business Law Section of the Maryland State Bar Association, Frederic W. Cook & Co., Inc., Graef Crystal, Davis Polk, General Mills, Inc., Glass Lewis, Grahall Partners, LLC., Honeywell, JP Morgan Chase & Co., RiskMetrics, SCSGP, SIFMA, and S&C. These commenters suggested this approach would better align the amounts reported in the Summary Compensation Table with the compensation decisions discussed in CD&A, and clarify the relationship between pay and performance

[74] See letters from Buck Consultants, Compensia, Pearl Meyer, Protective Life Corporation, and United Brotherhood of Carpenters.

[75] Instruction 1 to Item 402(c)(2)(iii) and (iv) provides that if the amount of salary or bonus earned for the fiscal year cannot be calculated as of the most recent practicable date, footnote disclosure of this fact and the date the amount is expected to be determined is required. When determined, the omitted amount and a recalculated total compensation figure must be reported in a filing under Item 5.02(f) of Form 8-K [17 CFR 249.308].

[76] See letter from Compensia.

executive officers' compensation for the last fiscal year,[77] and consider including supplemental tabular disclosure where it facilitates understanding the CD&A.

Although we proposed to revise Instruction 2 to the salary and bonus column of the Summary Compensation Table so that companies would not be required to report in those columns the amount of salary or bonus forgone at a named executive officer's election and the non-cash awards received instead of salary or bonus would be reported in the column applicable to the form of award elected, we have decided not to adopt this amendment. We agree with commenters that disclosing the amounts of salary and bonus that the compensation committee awarded better enables investors to understand the relative weights the company applied to annual incentives and salary.[78] This information provides investors more insight into the extent to which a company's compensation strategy pays for performance, may be heavily weighted in salary, or may be heavily weighted in annual incentives. Consistent with our decision to amend our rules to require disclosure enabling investors to better understand the risks involved in compensation programs, we are retaining the current version of this instruction, so that investors can understand overall compensation strategy and the intended distribution of risk among different types of compensation. Companies will continue to report the forgone amounts in the salary or bonus column, with footnote disclosure of the receipt of non-cash compensation that refers to the Grants of Plan-Based Awards Table where the stock, option or non-equity incentive plan award the named executive officer elected is reported.[79]

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[77] Instruction 2 to Item 402(b).

[78] See, e.g., letters from Center on Executive Compensation and Pearl Meyer.

[79] Instruction 2 to Item 402(c)(2)(iii) and (iv).

Finally, based on the comments received, we have decided not to rescind, as was proposed, the requirement to report the full grant date fair value of each equity award in the Grants of Plan-Based Awards Table and the Director Compensation Table. We agree with commenters that, because this disclosure reveals the value associated with each type of equity award granted and the mix of values among various awards with different incentive effects, retaining it will help investors better evaluate the decisions of the compensation committee.[80]

d. Transition

To facilitate year-to-year comparisons, consistent with our proposal, we will implement the Summary Compensation Table amendments by requiring companies providing Item 402 disclosure for a fiscal year ending on or after December 20, 2009 to present recomputed disclosure for each preceding fiscal year required to be included in the table, so that the stock awards and option awards columns present the applicable full grant date fair values, and the total compensation column is correspondingly recomputed.[81] The stock awards and option awards columns amounts should be computed based on the individual award grant date fair values reported in the applicable year's Grants of Plan-Based Awards Table, except that awards with performance conditions should be recomputed to report grant date fair value based on the probable outcome as of the grant date, consistent with FASB ASC Topic 718. In addition, if a person who would be a named executive officer for the most recent fiscal year (2009) also was disclosed as a named executive officer for 2007, but not for 2008, the named executive officer's

[80] See letters from Center on Executive Compensation and Pearl Meyer.

[81] Commenters generally favored this approach as a means of ensuring year-to-year comparability, and said it would not be difficult to comply. See, e.g., letters from Glass Lewis, Mercer, and Pfizer.

compensation for each of those three fiscal years must be reported pursuant to the amendments.[82] However, companies are not required to include different named executive officers for any preceding fiscal year based on recomputing total compensation for those years pursuant to the amendments, or to amend prior years' Item 402 disclosure in previously filed Forms 10-K or other filings.

e. Comment Responses Regarding Rulemaking Petition and Other Requests for Comment

We requested comment regarding a rulemaking petition recommending Summary Compensation Table disclosure of stock and option awards based on the annual change in value of awards.[83] We also requested comment on whether any potential amendments to the Grants of Plan-Based Awards Table or the Outstanding Equity Awards at Fiscal Year-End Table should be considered to better illustrate the relationship between pay and company performance. Most commenters did not support the petition's recommendation because they believed it would not report the board's compensation decisions, on which investors focus in making voting and investment decisions, and could result in disclosure of negative numbers.[84] However, several commenters recommended other tabular revisions to highlight how compensation may be related to the company's performance.[85] Most of these suggestions were in anticipation that legislation

[82] However, a smaller reporting company, which is required to provide disclosure only for the two most recent fiscal years, could provide Summary Compensation Table disclosure only for 2009 if the person was a named executive officer for 2009 but not for 2008.

[83] See May 26, 2009, rulemaking petition submitted by Ira T. Kay and Steven Seelig, Watson Wyatt Worldwide, File No. 4-585, at http://www.sec.gov/rules/petitions/2009/petn4-585.pdf.

[84] See, e.g., letters from Protective Life Corporation, RiskMetrics.

[85] See, e.g., letters from Center on Executive Compensation, Graef Crystal, Paul Hodgson, Don Meiers and Dan Gode.

establishing an annual "say-on-pay" shareholder advisory vote may be enacted.[86] Commenters most frequently recommended adding a column to the Outstanding Equity Awards at Fiscal Year-End Table to report the fiscal year end intrinsic value of outstanding options and stock appreciation rights ("SARs").[87]

In addition, we solicited comment on whether there are other initiatives we should consider proposing to improve executive compensation disclosure, such as including disclosure of each executive officer's compensation, not just the named executive officers; eliminating the instruction providing that performance targets can be excluded based on the potential adverse competitive effect on the company of their disclosure; making the CD&A part of the Compensation Committee Report, and requiring the report to be "filed;" additional disclosure regarding "hold to retirement" and/or claw back provisions; and internal pay ratios.[88] Commenters who addressed these topics expressed mixed views.[89]

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[86] The United States House of Representatives has passed H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009, which would provide shareholders an advisory vote to approve the compensation of executives in any proxy, consent, or authorization for an annual meeting.

[87] See, e.g., letters from Cleary Gottlieb, Compensia, Grant Thornton, Hewitt, Pearl Meyer, and Towers Perrin. We would not object if companies voluntarily add a column captioned "Value of unexercised in-the-money options/SARs at fiscal year end ($)" to the Outstanding Awards at Fiscal Year-End Table to report these fiscal year end intrinsic values.

[88] See Proposing Release at Section II.H.

[89] Commenters who addressed these topics generally opposed expanding executive compensation disclosure beyond the named executive officers, stating that it would not add meaningful information. See, e.g., letters from BorgWarner, Business Roundtable, Hewitt, Pearl Meyer, SCSGP and SIFMA. Some commenters opposed eliminating the ability to omit disclosure of performance targets based on competitive harm to the company, stating that disclosure would discourage use of performance targets or that adverse consequences to the company would outweigh the targets' informative value to investors. See, e.g., letters from BorgWarner, Business Roundtable, SCSGP, and Pearl Meyer (supporting disclosure of the percentage of target awards actually earned). Other commenters supported requiring retrospective disclosure of performance targets for awards in completed periods. See letters from RiskMetrics, SEIU, State Board of Administration of Florida, and Towers Perrin (supporting the competitive harm exclusion for performance cycles in effect when the proxy statement is distributed). Some commenters supported making CD&A part of the Compensation Committee Report as a means to improve CD&A disclosure quality, often recommending that the combined document be "filed." See letters from AFL-CIO, Jesse M. Brill, United Brotherhood of Carpenters, Hodak Value Advisors, RiskMetrics, and SEIU. Others supported retaining the current disclosure roles and status of the CD&A and Compensation Committee Report, finding no compelling reasons to change them. See, e.g., letters from Ameriprise Financial, Pearl Meyer, and SIFMA. Some

Our goal at this stage is to adopt discrete amendments to improve compensation disclosure in proxy statements, such as the changes to option reporting in the Summary Compensation Table and Director Compensation Table, that can be implemented for the 2010 proxy season. Therefore, we are not adopting any other changes to executive compensation disclosure at this time. However, we will consider the comments received in connection with future rulemaking initiatives on compensation disclosure.

B. Enhanced Director and Nominee Disclosure

We proposed to amend Item 401 of Regulation S-K to expand the disclosure requirements regarding the qualifications of directors and nominees, past directorships held by directors and nominees, and the time period for disclosure of legal proceedings involving directors, nominees and executive officers. We are adopting the changes generally as proposed, but have made revisions in response to comments.

1. Proposed Amendments

Under the proposed amendments, a company would be required to disclose for each director and any nominee for director the particular experience, qualifications, attributes or skills that qualified that person to serve as a director of the company, and as a member of any committee that the person serves on or is chosen to serve on, in light of the company's business. In addition to the expanded narrative disclosure regarding director and nominee qualifications, the proposed amendments would require disclosure of any directorships held by each director

commenters favored requiring enhanced disclosure of hold-to-retirement and clawback policies to demonstrate whether compensation practices foster a long-term value approach. See letters from Jesse M. Brill, SEIU, and State Board of Administration of Florida. Others opposed adding specific requirements, often noting that if such policies are material to compensation decisions, principles-based CD&A currently subjects them to disclosure. See, e.g., letters from Buck Consultants, Business Roundtable, Pearl Meyer, and Towers Perrin. Commenters similarly divided about requiring disclosure of internal pay ratios. See letters from Jesse M. Brill, Pearl Meyer, SCSGP and SIFMA. One commenter opposed all of the potential initiatives on which we solicited comment, stating that they "would generate extensive disclosures of questionable relevance." See letter from Pfizer.

and nominee at any time during the past five years at public companies and registered investment companies, and would lengthen the time during which disclosure of legal proceedings involving directors, director nominees and executive officers is required from five to ten years. As proposed, this expanded disclosure would apply to incumbent directors, to nominees for director who are selected by a company's nominating committee, and to any nominees put forward by another proponent in its proxy materials.

We proposed that the disclosures under the Item 401 amendments would appear in proxy and information statements on Schedules 14A and 14C, annual reports on Form 10-K and registration statements on Form 10 under the Exchange Act, as well as in registration statements under the Securities Act.

We also proposed to apply the expanded disclosure requirements regarding director and nominee qualifications, past directorships held by directors and nominees, and the time frame for disclosure of legal proceedings involving directors, nominees, and executive officers to funds. Specifically, we proposed to amend Schedules 14A and 14C to apply these expanded requirements to fund proxy and information statements, where action is to be taken with respect to the election of directors, and to amend Forms N-1A, N-2, and N-3 to require that funds include the expanded disclosures regarding director qualifications and past directorships in their statements of additional information.[90]

2. Comments on the Proposed Amendments

Comments on the proposal were mixed. Individual investors, trade unions, institutional investors and pension funds supported the proposals. Several of these commenters noted that the

[90] Form N-1A is used by open-end management investment companies. Form N-2 is used by closed-end management investment companies. Form N-3 is used by separate accounts, organized as management investment companies, which offer variable annuity contracts.

amendments would be a helpful step forward in providing investors and shareholders with additional information they need to make more informed investment and voting decisions relating to corporate governance and the election of directors.[91] Most companies, law firms and bar groups opposed the proposal. Many of the commenters opposed to the proposed amendments expressed concern about requiring companies to disclose the qualifications, attributes and skills of directors and nominees on a person-by-person basis.[92] Some of these commenters believed that requiring disclosure of the qualifications, attributes and skills of directors and nominees on a person-by-person basis would not elicit meaningful disclosure. They asserted that well-assembled boards usually consist of a diverse collection of individuals who bring a variety of complementary skills that nominating committees and boards generally consider in the broader context of the board's overall composition, with a view toward constituting a board that, as a body, possesses the appropriate skills and experience to oversee the company's business. Another concern expressed by commenters opposed to the proposed amendments was that the disclosure of specialized knowledge or background of particular directors could lead to heightened liability.[93]

Commenters also objected to the use of term "qualify" in the proposed amendment. They noted that the term "qualify" would only be relevant to the extent that a company's governing instruments create minimum qualifications for directors, such as a requirement to own a certain amount of shares in the company.[94] Other commenters believed that "risk assessment skills"

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[91] See, e.g., letters from Board of Directors Network, Forum of Executive Women, Integrated Governance Solutions, Norges Bank Investment Management ("Norges Bank"), and Ralph Saul.

[92] See, e.g., letters from ABA, Ameriprise, Business Roundtable, BorgWarner, Davis Polk, Honeywell, JPMorgan, Southern Company ("Southern"), and Wisconsin Energy.

[93] See, e.g., letters from ABA, Ameriprise and Business Roundtable.

[94] See letter from ABA.

should not be singled out for specific discussion, but rather should be considered as part of the discussion of the board's aggregate skills and attributes.[95] These commenters stated that a better alternative may be to address risk as separate disclosure topic to elicit more detailed disclosure about risk.

Several commenters believed that it would be inappropriate to require disclosure of the specific experience, qualifications or skills that qualify a person to serve as a member of a particular board committee.[96] According to these commenters, other than having a least one member of the board with "financial expertise" satisfying the requirements for the audit committee, companies generally do not select individuals to serve on the board based on what committee they will serve on. These commenters noted that in many instances, companies will rotate directors among several committee positions during their tenure on the board.[97]

On the question of how frequently the disclosure should be required, many commenters supported having the disclosure provided on an annual basis for all continuing directors and new nominees.[98] These commenters noted that the overall composition of the board changes when new nominees are introduced and annual disclosure would facilitate shareholders' assessments of the quality of the board as a whole, which must be analyzed in relation to any changes in the company's strategy, relevant risks, operations and organization. However, several other commenters stated that if the requirements are adopted, they should only be required when a director is first nominated.[99]

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[95] See, e.g., letters from Honeywell and Protective Life Corporation.

[96] See letters from SCSGP, S&C and Southern.

[97] See, e.g., letters from SCSGP and S&C.

[98] See, e.g., letters from IIA, Norges Bank, Pax World Management Corporation, and RiskMetrics.

[99] See letters from BorgWarner, Business Roundtable, Cleary Gottlieb, SCSGP and S&C.

A broad spectrum of commenters supported the proposed amendments to require disclosure of any directorships at public companies held by each director and nominee at any time during the past five years instead of only currently held directorships, and to lengthen the time during which disclosure of legal proceedings is required from five to ten years.[100] However, other commenters asserted that additional disclosure of past directorships would become voluminous and tend to obfuscate a nominee's most relevant credentials.[101]

We requested comment on whether we should retain Item 407(c)(2)(v) of Regulation S-K in light of the proposed amendments to Item 401 of Regulation S-K. This item, among other things, requires disclosure of any minimum qualifications that a nominating committee believes must be met by someone nominated by a committee for a position on the board. Several commenters believed we should retain the disclosure currently required by Item 407(c)(2)(v) because this information allows shareholders to gain an understanding of the overall quality of the board and the board's priorities, and would improve the ability of shareholders to compare a nominee's background to the standards set by the board itself and to further evaluate board and committee composition.[102]

We also requested comment on whether there were additional legal proceeding disclosures that reflect on a director's, executive officer's, or nominee's character and fitness to serve as a public company official that should be required to be disclosed, and we listed several possible additions to the current list. Several commenters agreed that the disclosure about the

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[100] See, e.g., letters from AARP, AFL-CIO, CII, Evolution Petroleum, Pfizer, RILA, SCSGP, TIAA-CREF, United Brotherhood of Carpenters, and Universities Superannuation Scheme, et al. Cf. letters from AFSCME and Florida State Board of Administration (supporting the proposed amendment and also suggesting that the disclosure of legal proceedings involving fraud should not be subject to a time limit).

[101] See, e.g., letter from S&C.

[102] See, e.g., letters from ABA and CII.

additional legal proceedings noted was important information that reflected on an individual's competence and integrity and as such, should be disclosed.[103] Other commenters believed the current disclosure requirements were adequate.[104]

3. Final Rule

After considering the comments, we are adopting the amendments to Item 401, but with several revisions. We believe the amendments will provide investors with more meaningful disclosure that will help them in their voting decisions by better enabling them to determine whether and why a director or nominee is an appropriate choice for a particular company.

The final rules require companies to disclose for each director and any nominee for director the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director for the company as of the time that a filing containing this disclosure is made with the Commission.[105] The same disclosure, with respect to any nominee for director put forward by another proponent, would be required in the proxy soliciting materials of that proponent. This new disclosure will be required for all nominees and for all directors, including those not up for reelection in a particular year. The final rule requires this disclosure to be made annually because the composition of the entire board is important information for voting decisions. Although we are adopting the amendments to Item 401, we are not eliminating the disclosure requirements in Item 407(c)(2)(v) of Regulation S-K regarding the specific minimum qualifications and specific qualities or skills used by the nominating committee. We agree with commenters that this requirement should be retained because it will

[103] See, e.g., letters from AARP, Colorado Public Employees' Retirement Association ("COPERA"), and Interfaith Center on Corporate Responsibility.

[104] See, e.g., letters from American Electric Power and S&C.

[105] Consistent with the comments, we are revising the requirement to delete the term "qualify," and instead we are focusing on the reasons for the decision that the person should serve as a director.

allow investors to compare and evaluate the skills and qualifications of each director and nominee against the standards established by the board.[106]

The final rules do not require disclosure of the specific experience, qualifications or skills that qualify a person to serve as a committee member. In making this change from the proposal, we were persuaded by commenters who noted that many companies rotate directors among different committee positions to allow directors to gain different perspectives of the company.[107] However, if an individual is chosen to be a director or a nominee to the board because of a particular qualification, attribute or experience related to service on a specific committee, such as the audit committee, then this should be disclosed under the new requirements as part of the individual's qualifications to serve on the board.

The final amendments do not specify the particular information that should be disclosed. We believe companies and other proponents should be afforded flexibility in determining the information about a director's or nominee's skills, qualifications or particular area of expertise that would benefit the company and should be disclosed to shareholders. Accordingly, we have deleted the reference to "risk assessment skills" that was included in the proposed amendments.[108] However, we note that if particular skills, such as risk assessment or financial reporting expertise, were part of the specific experience, qualifications, attributes or skills that led the board or proponent to conclude that the person should serve as a director, this should be disclosed.

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[106] See, e.g., letter from CII.

[107] See, e.g., letters from Davis Polk and Pfizer.

[108] See, e.g., letters from Honeywell and Protective Life Corporation.

We are adopting substantially as proposed the amendments to require disclosure of any directorships at public companies and registered investment companies held by each director and nominee at any time during the past five years. Item 401 presently requires disclosure of any current director positions held by each director and nominee in any company with a class of securities registered pursuant to Section 12 of the Exchange Act,[109] or subject to the requirements of Section 15(d) of that Act,[110] or any company registered as an investment company under the Investment Company Act. We believe that expanding this disclosure to include service on boards of those companies for the past five years (even if the director or nominee no longer serves on that board) will allow investors to better evaluate the relevance of a director's or nominee's past board experience, as well as professional or financial relationships that might pose potential conflicts of interest (such as past membership on boards of major suppliers, customers, or competitors).

In addition to these amendments, we are adopting amendments as proposed to lengthen the time during which disclosure of legal proceedings involving directors, director nominees and executive officers is required from five to ten years. We believe it is appropriate to extend the required reporting period from five to ten years as a means of providing investors with more extensive information regarding an individual's competence and character. We were persuaded by commenters who believed that disclosures of legal proceedings during the ten-year period would provide investors with additional important information.[111] We are also adopting amendments to expand the list of legal proceedings involving directors, executive officers, and

[109] 15 U.S.C. 78l.

[110] 15 U.S.C. 78o(d).

[111] See, e.g., letters from ABA, AARP and COPERA.

nominees covered under Item 401(f) of Regulation S-K. Some commenters agreed that certain legal proceedings can reflect on an individual's competence and integrity to serve as a director, and that the additional disclosure noted in the proposing release would provide investors with valuable information for assessing the competence, character and overall suitability of a director, nominee or executive officer.[112]

In addition, consistent with our request for comment and comments received,[113] we are amending Item 401(f) to require disclosure of additional legal proceedings. These new legal proceedings include:

- Any judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity;
- Any judicial or administrative proceedings based on violations of federal or state securities, commodities, banking or insurance laws and regulations, or any settlement[114] to such actions; and
- Any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

We believe this amendment will provide investors with information that is important to an evaluation of an individual's competence and character to serve as a public company official.[115]

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[112] See, e.g., letters from AARP, CII, COPERA, SEIU, and USPX.

[113] See note 103 above and accompanying text.

[114] This does not include disclosure of a settlement of a civil proceeding among private parties. We are including an instruction as part of the amendments to clarify this.

[115] Consistent with the current disclosure requirement regarding legal proceedings, the additional legal proceedings included in the new requirements will not need to be disclosed if they are not material to an evaluation of the ability or integrity of the director or director nominee. See 17 CFR 229.401(f).

In the Proposing Release, we also requested comment on whether we should amend our rules to require disclosure of additional factors considered by a nominating committee when selecting someone for a board position, such as board diversity. A significant number of commenters responded that disclosure about board diversity was important information to investors.[116] Many of these commenters believed that requiring this disclosure would provide investors with information on corporate culture and governance practices that would enable investors to make more informed voting and investment decisions.[117] Commenters also noted that there appears to be a meaningful relationship between diverse boards and improved corporate financial performance, and that diverse boards can help companies more effectively recruit talent and retain staff.[118] We agree that it is useful for investors to understand how the board considers and addresses diversity, as well as the board's assessment of the implementation of its diversity policy, if any. Consequently, we are adopting amendments to Item 407(c) of Regulation S-K to require disclosure of whether, and if so how, a nominating committee considers diversity in identifying nominees for director.[119] In addition, if the nominating committee (or the board) has a policy with regard to the consideration of diversity in identifying director nominees, disclosure would be required of how this policy is implemented, as well as how the nominating committee (or the board) assesses the effectiveness of its policy. We

[116] See, e.g., letters from Board of Directors Network, Boston Common Asset Management, CalPERS, CalSTRS, Calvert, Council of Urban Professionals, Ernst & Young LLP ("E&Y"), Greenlining Institute, Hispanic Association on Corporate Responsibility, Interfaith Center on Corporate Responsibility, InterOrganization Network, Latino Business Chamber of Greater Los Angeles, Pax World Management Corporation, Prout Group, Inc., RiskMetrics, Sisters of Charity BVM, Sisters of St. Joseph Carondelet, and Trillium Asset Management Corporation.

[117] See, e.g., letters from the Boston Club, Boston Common Asset Management, CalPERS, Pax World Management Corporation, Trillium Asset Management Corporation, and Social Investment Forum.

[118] See, e.g., letters from Catalyst and the Social Investment Forum.

[119] See Item 407(c)(2)(vi) of Regulation S-K. Funds will be subject to the diversity disclosure requirement of Item 407(c)(2)(vi) of Regulation S-K under Item 22(b)(15)(ii)(A) of Schedule 14A. See 17 CFR 240.14a-101, Item 22(b)(15)(ii)(A).

recognize that companies may define diversity in various ways, reflecting different perspectives. For instance, some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin. We believe that for purposes of this disclosure requirement, companies should be allowed to define diversity in ways that they consider appropriate. As a result we have not defined diversity in the amendments.

C. New Disclosure about Board Leadership Structure and the Board's Role in Risk Oversight

We proposed a new disclosure requirement to Item 407 of Regulation S-K and a corresponding amendment to Item 7 of Schedule 14A to require disclosure of the company's leadership structure and why the company believes it is the most appropriate structure for it at the time of the filing. The proposal also required disclosure about the board's role in the company's risk management process. We are adopting the proposals with some changes.

1. Proposed Amendments

Under the proposed amendments, companies would be required to disclose their leadership structure and the reasons why they believe that it is an appropriate structure for the company. As part of this proposed disclosure, companies would be required to disclose whether and why they have chosen to combine or separate the principal executive officer and board chair positions. In addition, in some companies the role of principal executive officer and board chairman are combined, and a lead independent director is designated to chair meetings of the independent directors. For these companies, the proposed amendments would require disclosure of whether and why the company has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the company. In proposing this requirement, we noted that different leadership structures may be suitable for different companies depending on factors such as the size of a company, the nature of a company's business, or internal control considerations, among other things. Irrespective of the type of leadership structure selected by a company, the proposed requirements were intended to provide investors with insights about why the company has chosen that particular leadership structure.

We also proposed to require additional disclosure in proxy and information statements about the board's role in the company's risk management process. Disclosure about the board's approach to risk oversight might address questions such as whether the persons who oversee risk management report directly to the board as whole, to a committee, such as the audit committee, or to one of the other standing committees of the board; and whether and how the board, or board committee, monitors risk.

We also proposed that funds provide the new Item 407 disclosure about leadership structure and the board's role in the risk management process in proxy and information statements and similar disclosure as part of registration statements on Forms N-1A, N-2 and N-3. The proposed amendments were tailored to require that a fund disclose whether the board chair is an "interested person" of the fund, as defined in Section 2(a)(19) of the Investment Company Act. We proposed that if the board chair is an interested person, a fund would be required to disclose whether it has a lead independent director and what specific role the lead independent director plays in the leadership of the fund.

2. Comments on the Proposed Amendments

Comments were mostly supportive of the proposals.[120] Commenters believed the disclosure regarding a company's leadership structure and the board's role in risk management

[120] See, e.g., letters from AFL-CIO, Chairmen's Forum, Calvert, CII, CalSTRS, the General Board of Pension and Health Benefits of the United Methodist Church, Hermes, Norges Bank, Pfizer, RiskMetrics, and SEIU.

process would provide useful information to investors and improve investor understanding of the role of the board in a company's risk management practices.[121] Some commenters opposed the disclosures. Many of these commenters believed that the proposed amendments were too vague and would likely elicit boilerplate descriptions of a company's management hierarchy and risk management that would not provide significant insight or meaning to investors.[122]

Many commenters suggested revisions to the proposed disclosure requirements. For instance, several commenters recommended that we use the phrase "board leadership structure" rather than "company leadership structure" and noted that the discussion of the board leadership structure and the board's role in risk management are two separate disclosure items.[123] These commenters believed that the use of the phrase "company leadership structure" could be misinterpreted to require a discussion of a company's management leadership structures. Other commenters suggested that we replace the phrase "risk management" with "risk oversight" because the board's role is to oversee management, which is responsible for the day-to-day issues of risk management.[124]

Several commenters believed disclosure of the board's role in risk management would be more effective as part of a comprehensive discussion of a company's risk management processes, rather than as stand-alone disclosure.[125] They suggested that companies be allowed to provide the required disclosure in the MD&A discussion included in the Form 10-K, and to

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[121] See, e.g., letters from CII, the General Board of Pension and Health Benefits of the United Methodist Church, IGS, and RIMS.

[122] See, e.g., letters from Cleary Gottlieb, S&C and Theragenics.

[123] See, e.g., letters from Business Roundtable and Honeywell.

[124] See, e.g., letters from GovernanceMetrics and PLC.

[125] See, e.g., letters from ABA and JPMorgan.

incorporate by reference this information in the proxy statement rather than repeat the information.

With respect to funds, commenters addressing the issue generally supported the proposal that funds disclose whether the board chair is an "interested person" as defined under the Investment Company Act.[126] In addition, commenters noted the importance of fund board oversight of risk management,[127] but commenters were split regarding whether we should require disclosure about fund board oversight of risk management.[128]

3. Final Rule

After consideration of the comments, we are adopting the proposals substantially as proposed with a few technical revisions in response to comments. We believe that, in making voting and investment decisions, investors should be provided with meaningful information about the corporate governance practices of companies.[129] As we noted in the Proposing Release, one important aspect of a company's corporate governance practices is its board's leadership structure. Disclosure of a company's board leadership structure and the reasons the company believes that its board leadership structure is appropriate will increase the transparency for investors as to how the board functions.

As stated above, the amendments were designed to provide shareholders with disclosure of, and the reasons for, the leadership structure of a company's board concerning the principal

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[126] See, e.g., letters from Independent Directors Council ("IDC") and Mutual Fund Directors Forum ("MFDF").

[127] See, e.g., letters from IDC and MFDF.

[128] See letters from Calvert and MFDF (supporting disclosure). But see letters from the Investment Company Institute and IDC (opposing disclosure).

[129] See, e.g., National Association of Corporate Directors, Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies, (Mar. 2009) ("Every board should explain, in proxy materials and other communications with shareholders, why the governance structures and practices it has developed are best suited to the company.").

executive officer, the board chairman position and, where applicable, the lead independent director position. We agree with commenters that the phrase "board leadership structure" instead of "company leadership structure" would avoid potential misunderstanding that the amendments require a discussion of the structure of a company's management leadership.[130] We also agree with commenters that the phrase "risk oversight" instead of "risk management" would be more appropriate in describing the board's responsibilities in this area.[131]

Under the amendments, a company is required to disclose whether and why it has chosen to combine or separate the principal executive officer and board chairman positions, and the reasons why the company believes that this board leadership structure is the most appropriate structure for the company at the time of the filing. In addition, in some companies the role of principal executive officer and board chairman are combined, and a lead independent director is designated to chair meetings of the independent directors. In these circumstances, the amendments will require disclosure of whether and why the company has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the company. As we previously stated in the Proposing Release, these amendments are intended to provide investors with more transparency about the company's corporate governance, but are not intended to influence a company's decision regarding its board leadership structure.

The final rules also require companies to describe the board's role in the oversight of risk. We were persuaded by commenters who noted that risk oversight is a key competence of the board, and that additional disclosures would improve investor and shareholder understanding of

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[130] See letter from Honeywell.

[131] See, e.g., letters from Ameriprise Financial and Protective Life Corporation.

the role of the board in the organization's risk management practices.[132] Companies face a variety of risks, including credit risk, liquidity risk, and operational risk. As we noted in the Proposing Release, similar to disclosure about the leadership structure of a board, disclosure about the board's involvement in the oversight of the risk management process should provide important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company. This disclosure requirement gives companies the flexibility to describe how the board administers its risk oversight function, such as through the whole board, or through a separate risk committee or the audit committee, for example. Where relevant, companies may want to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as a whole or to a board committee or how the board or committee otherwise receives information from such individuals.

The final rules also require funds to provide disclosure about the board's role in risk oversight. Funds face a number of risks, including investment risk, compliance, and valuation; and we agree with commenters who favored disclosure of board risk oversight by funds.[133] As with corporate issuers, we believe that additional disclosures would improve investor understanding of the role of the board in the fund's risk management practices. Furthermore, the disclosure should provide important information to investors about how a fund perceives the role of its board and the relationship between the board and its advisor in managing material risks facing the fund.

[132] See, e.g., letters from Norges Bank and RIMS.

[133] See letters from Calvert and MFDF.

D. New Disclosure Regarding Compensation Consultants

We proposed amendments to Item 407 of Regulation S-K to require, for the first time, disclosure about the fees paid to compensation consultants and their affiliates when they played a role in determining or recommending the amount or form of executive and director compensation, and they also provided additional services to the company. The proposed amendments also would have required a description of the additional services provided to the company by the compensation consultants and any affiliates of the consultants. We are adopting the amendments with changes in response to comments.

1. Proposed Amendments

Under the proposed amendments to Item 407, if a compensation consultant or its affiliates played a role in determining or recommending the amount or form of executive and director compensation, and also provided additional services, then the company would be required to disclose the following:

- The nature and extent of all additional services provided to the company or its affiliates during the last fiscal year by the compensation consultant and any affiliates of the consultant;
- The aggregate fees paid for all additional services, and the aggregate fees paid for work related to determining or recommending the amount or form of executive and director compensation;
- Whether the decision to engage the compensation consultant or its affiliates for non-executive compensation services was made, recommended, subject to screening or reviewed by management; and

- Whether the board of directors or the compensation committee has approved the other services provided by the compensation consultant in addition to executive compensation services.

The proposed disclosure requirements would have applied to all services provided by a compensation consultant and its affiliates if the compensation consultant played any role in determining or recommending the amount or form of executive and director compensation. The proposed amendments did not distinguish between consultants engaged by the board and consultants engaged by management. We provided an exception from the proposed disclosure requirements for those situations in which the compensation consultant's role in recommending the amount or form of executive and director compensation was limited to consulting on broad-based plans that did not discriminate in favor of executive officers or directors of the company, such as 401(k) plans or health insurance plans. We believed that when a compensation consultant's services were limited to consulting on broad-based, non-discriminatory plans, these services did not give rise to the type of potential conflict of interest intended to be addressed by our proposed amendments.[134]

2. Comments on the Proposed Amendments

A significant number of commenters generally supported the proposed amendments to Item 407 of Regulation S-K to require disclosure of the fees paid to compensation consultants as well as a description of other services provided by compensation consultants.[135] Many of these

[134] We also proposed to amend Item 407 along the same lines to clarify that the current disclosure requirements under the item were not triggered for a compensation consultant whose only services with regard to executive or director compensation were limited to these types of broad-based, non-discriminatory plans. Many commenters supported this amendment and we are adopting it as proposed.

[135] See, e.g., letters from AFL-CIO, AFSCME, Business Roundtable, CalSTRS, CII, COPERA, Evolution Petroleum, Glass Lewis, Grahall, Hermes Equity Ownership Services, NACD, Oppenheimer Funds, Pax World Management Corporation, State of Connecticut Treasurer's Office, TIAA-CREF, Trillium Asset Management Corporation, and Walden Asset Management.

commenters believed investors would benefit from disclosure regarding the potential conflicts of interests of compensation consultants when they advise on the amount or form of executive and director compensation and also provide additional services to the company.[136] These commenters believed that disclosure of the fees paid to compensation consultants would go a long way towards minimizing potential conflicts of interests and would allow shareholders to assess the potential conflicts of interest in regard to the compensation advice given to companies.

However, several commenters, primarily multi-service compensation consulting firms, opposed the proposed amendments.[137] These commenters believed the proposed amendments were too narrowly focused on fees paid to multi-service consulting firms and ignored important considerations relating to the consultant's qualifications, selection, and role.[138] They also asserted that the proposed disclosure could give investors a distorted view of how companies use and select compensation consultants. Because the role of consultants is not uniform and varies considerably from company to company, these commenters asserted that investors should be given an understanding not only of the role consultants serve for each company, but also of the board's or compensation committee's selection process. This would include how it assessed the consultant's qualifications and how any potential conflicts of interest that may have been identified are mitigated by formal processes, or by the internal controls and processes maintained by the consulting firm.[139]

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[136] See, e.g., letters from AFL-CIO, Frank Inman, Hermes Equity Ownership Services Ltd., TIAA-CREF, and Trillium Asset Management.

[137] See letters from ABA, Hewitt, Mercer, Pfizer, Protective Life Corporation, Radford, Towers Perrin, Value Alliance, and Watson Wyatt.

[138] See, e.g., letters from Hewitt, Mercer and Towers Perrin.

[139] See, e.g., letter from Hewitt.

Several commenters opposed to the proposed amendments asserted that the amendments would decrease the compensation consulting resources available to companies.[140] Other commenters asserted that the proposed amendments would cause competitive harm to multi-service consulting firms who provide services other than executive compensation consulting, as companies would be discouraged from using multi-service compensation consulting firms in more than one capacity.[141] These commenters also claimed that the proposed amendments would cause competitive harm because disclosure of the nature and extent of all additional services provided by the consultant would reveal confidential and competitively sensitive pricing information that could allow competitors to determine the fee structure for these additional services.[142]

These commenters also expressed concern that the proposed amendments did not address potential conflicts of interest that may occur when a compensation consultant that only provides executive-compensation related services to the board is overly reliant on the fees it receives from a particular client. They suggested an alternative rule that would require disclosure of fees paid to a compensation consultant when a significant portion of the annual revenues of the compensation consultant were generated from any one client.[143]

Several commenters expressed concern that the scope of the proposed amendments was too broad. These commenters believed that when a compensation committee engages its own compensation consultant, it mitigates any concerns about potential conflicts of interest involving

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[140] See, e.g., letters from Hewitt and Mercer.

[141] See, e.g., letters from Mercer, Towers Perrin and Watson Wyatt.

[142] See, e.g., letter from Mercer.

[143] See, e.g., letters from Hewitt, Mercer, Towers Perrin and Watson Wyatt.

consultants engaged by management.[144] According to these commenters, from that perspective, a compensation consulting firm that provides executive compensation consulting services to the company, and also provides other services to the company, would not present a conflict of interest issue when the compensation committee retains a different consultant.[145] Noting that management should have broad access to compensation experts and other third parties when developing executive pay proposals for board consideration, and that it is the board's responsibility to evaluate management's compensation proposals when determining whether or not to approve them, some commenters expressed concerns about the potential effect of the proposed disclosure on the board's discharge of its oversight responsibility.[146]

In the Proposing Release, we requested comment on whether there were other consulting services that do not give rise to potential conflicts of interest that should be excluded from the proposed disclosure requirements similar to the proposed exemption for consulting services that are limited to broad-based, non-discriminatory plans. Several commenters responded by suggesting that we exclude consulting services where the compensation consultant only provides the board with peer surveys that provide general information regarding the forms and amounts of compensation typically paid to executive officers and directors within a particular industry.[147] Another commenter suggested that surveys that are either not customized for a particular company, or that are customized based on parameters that are not developed by the compensation consultant, should be excluded from the amendments.[148] These commenters

[144] See, e.g., letters from E&Y and Deloitte.

[145] Id.

[146] See letters from Hewitt and E&Y.

[147] See, e.g., letters from BorgWarner, Davis Polk, Honeywell, JPMorgan and Wisconsin Energy.

[148] See letter from ABA.

believed that in situations where the compensation consultant's services provided to a company were limited to providing those types of surveys, such services did not raise the potential conflicts of interest that the proposed amendments were intended to address.[149]

We also requested comment on whether we should establish a disclosure threshold based on the amount of the fees for the non-executive compensation related services, such as above a certain dollar amount or a percentage of income or revenues. Several commenters recommended that the proposed amendments should include a disclosure threshold, including many who suggested that we should require disclosure only if the aggregate fees for all additional services provided by the consultant and its affiliates exceeded $120,000.[150]

3. Final Rule

After considering the comments received, we are adopting a modified version of the proposed amendments. We believe the new disclosure requirements will provide investors with information that will enable them to better assess the potential conflicts a compensation consultant may have in recommending executive compensation, and the compensation decisions made by the board. As we noted in the Proposing Release, many companies engage compensation consultants to make recommendations on appropriate executive and director compensation levels, to design and implement incentive plans, and to provide information on industry and peer group pay practices. The services offered by compensation consultants, however, are often not limited to recommending executive and director compensation plans or

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[149] See, e.g., letters from BorgWarner, Davis Polk and Honeywell.

[150] See, e.g., letters from ACC, Business Roundtable, Davis Polk, and SCSGP. Some commenters also suggested a disclosure threshold based on tests in effect under rules with a similar focus in self-regulatory organizations, such as the 2% (for New York Stock Exchange-listed companies) or 5% (for NASDAQ-listed companies) of gross revenues test for disclosure of business relationships between a company and a director-affiliated entity. See, e.g., letter from Cleary Gottlieb. See also, letter from ABA (suggesting a percentage threshold set at a level where the effect of such fees diminishes the possible appearance of a conflict of interest).

policies. Many compensation consultants, or their affiliates, are retained by management to provide a broad range of additional services, such as benefits administration, human resources consulting and actuarial services. The fees generated by these additional services may be more significant than the fees earned by the consultants for their executive and director compensation services. The extent of the fees and provision of additional services by a compensation consultant or its affiliate may create the risk of a conflict of interest that may call into question the objectivity of the consultant's advice and recommendations on executive compensation.

At the same time, we are persuaded that there are circumstances where this disclosure should not be required either because of the limited nature of the additional services or because of other factors that mitigate the concern that the board may be receiving advice potentially influenced by a conflict of interest.

a. Summary of the Final Rule

As more fully described below, under our final rule, in addition to the requirement under the current rule to describe the role of the compensation consultant in determining or recommending the amount or form of executive and director compensation, fee disclosure related to the retention of a compensation consultant will be required in certain circumstances. The final rules can be summarized generally as follows:

- If the board, compensation committee or other persons performing the equivalent functions (collectively, "board") has engaged its own consultant to provide advice or recommendations on the amount or form of executive and director compensation and the board's consultant or its affiliates provide other non-executive compensation consulting services to the company, fee and related disclosure is required, provided the fees for the non-executive compensation consulting services exceed $120,000 during the company's fiscal year. Disclosure is also required of whether the decision to engage the compensation consultant or its affiliates for non-executive compensation consulting services was made or recommended by management, and whether the board has approved these non-executive compensation consulting services provided by the compensation consultant or its affiliate;

- If the board has not engaged its own consultant, fee disclosures are required if there is a consultant (including its affiliates) providing executive compensation consulting services and non-executive compensation consulting services to the company, provided the fees for the non-executive compensation consulting services exceed $120,000 during the company's fiscal year;
- Fee and related disclosure for consultants that work with management (whether for only executive compensation consulting services, or for both executive compensation consulting and other non-executive compensation consulting services) is not required if the board has its own consultant; and
- Services involving only broad-based non-discriminatory plans or the provision of information, such as surveys, that are not customized for the company, or are customized based on parameters that are not developed by the consultant, are not treated as executive compensation consulting services for purposes of the compensation consultant disclosure rules.

b. Disclosure required if the board's compensation consultant provides additional services to the company

If the board has engaged a compensation consultant to advise the board as to executive and director compensation, and such consultant or its affiliates provides other non-executive compensation consulting services to the company, the disclosures specified by the new rules are required. We believe that in that situation, the receipt of fees for non-executive compensation consulting services by the board's consultant presents the potential conflict of interest intended to be highlighted for investors by our new rules. Subject to the disclosure threshold discussed below, the final rule requires disclosure of the aggregate fees paid for services provided to either the board or the company with regard to determining or recommending the amount or form of executive and director compensation, and the aggregate fees paid for any non-executive compensation consulting services provided by the compensation consultant or its affiliates.

In addition, the new rules require disclosure of whether the decision to engage the compensation consultant or its affiliates for the non-executive compensation consulting services was made, or recommended by, management, and whether the board approved such other services.[151]

c. Disclosure required if the board does not have a compensation consultant, but the company receives executive compensation and non-executive compensation services from its consultant

The new rule also requires disclosure of fees in situations where the board has not engaged a compensation consultant, but management or the company received executive compensation consulting services and other non-executive compensation consulting services from a consultant or its affiliates, and the fees from the non-executive compensation consulting services provided by that consultant or its affiliates exceed $120,000 for the company's fiscal year.[152] We recognize that in that situation the board, which generally is primarily responsible for determining the compensation paid to senior executives, may not be relying on the consultant used by management, and, therefore, conflicts of interest may be less of a concern. However, we

[151] Item 407(e)(3)(iii)(A) of Regulation S-K.

[152] Item 407(e)(3)(iii)(B).

believe that when management has a compensation consultant and the board does not have its own compensation consultant to help filter any advice provided by management's compensation consultant, the concerns about board reliance on consultants that may have a conflict are sufficiently present to require this approach. Consequently, the final rule provides that in this fact pattern, fee disclosure is required if the fees from the non-executive compensation consulting services provided by the compensation consultant exceed the disclosure threshold described below.

d. Disclosure not required if the board and management have different compensation consultants, even if management's consultant provides additional services to the company

In some instances, the board may engage a compensation consultant to advise it on executive or director compensation, and management may engage a separate consultant to provide executive compensation consulting services and one or more additional non-executive compensation consulting services. We believe there is less potential for a conflict of interest to arise when the board has retained its own compensation consultant, and the company or management has a different consultant to provide executive compensation consulting and other non-executive compensation consulting services.[153] When the board engages its own compensation consultant, it mitigates concerns about potential conflicts of interest involving compensation consultants engaged by management.[154] Accordingly, the final rules provide a limited exception to the disclosure requirements for fees paid to other compensation consultants retained by the company if the board has retained its own consultant that reports to the board. In addition to limiting disclosure to circumstances that are more likely to present potential conflicts

[153] See, e.g., letters from Hewitt and E&Y.

[154] See letter from E&Y.

of interests, we believe this approach should address some concerns about competitive harm that were raised by commenters. The exception would be available without regard to whether management's consultant participates in board meetings. Where the board's compensation consultant provides additional non-executive compensation consulting services to the company, the rule would, as described above, require fee and other related disclosures, which should address concerns about conflicts of interest by that consultant. Fee disclosure for services provided by management's compensation consultant would be less relevant in this situation because the board is able to rely on its own compensation consultant's advice, rather than the advice provided by management's compensation consultant, when making its executive compensation decisions.

e. Disclosure required only if fees for additional services exceed $120,000 during the company's last completed fiscal year

As noted previously, we agree with commenters that the final rule should have a disclosure threshold.[155] We believe that when aggregate fees paid for the non-executive compensation consulting services are limited, the potential conflict of interest is likely to be commensurately reduced. A disclosure threshold would also reduce the compliance burdens on companies when the potential conflict of interest is minimal. Under the rule as adopted, if the board has engaged a compensation consultant to provide executive and director compensation consulting services to the board or if the board has not retained a consultant but there is a firm providing executive compensation consulting services, fee disclosure is required if the consultant or its affiliates also provides other non-executive compensation consulting services to the company, and the fees paid for the other services exceed $120,000 for the company's fiscal year.

[155] See, e.g., letters from ACC, Davis Polk and SCSGP. This threshold requirement should also help address some of the competitive concerns expressed by some commenters. See, e.g., note 150 above and accompanying text.

We believe fees for other non-executive compensation consulting services below that threshold are less likely to raise potential conflicts of interest concerns, and note this disclosure threshold should reduce the recordkeeping burden on companies. This threshold is similar to the disclosure threshold for transactions with related persons in Item 404 of Regulation S-K, which also deals with potential conflicts of interest on the part of related persons who have financial transactions or arrangements with the company, and therefore provides some regulatory consistency.[156]

f. **Disclosure of nature and extent of additional services not required**

The rule, as adopted, does not require disclosure of the nature and extent of additional services provided by the compensation consultant and its affiliates to the company, as we proposed. We made this change from the proposal because we are persuaded by commenters who noted that requiring this disclosure could cause competitive harm by revealing confidential and sensitive pricing information, and we believe that the critical information about the potential conflict is adequately conveyed through the fee disclosure requirement. Although we are not adopting this requirement, companies may at their discretion include a description of any additional non-executive compensation consulting services provided by the compensation consultant and its affiliates where such information would facilitate investor understanding of the existence or nature of any potential conflict of interest.

g. **Exceptions to the disclosure requirement for consulting on broad-based plans and provision of survey information**

We are adopting substantially as proposed the exception from the disclosure requirements for situations in which the compensation consultant's only role in recommending the amount or form of executive or director compensation is in connection with consulting on broad-based

[156] See 17 CFR 229.404.

plans that do not discriminate in favor of executive officers or directors of the company. In addition, in response to comments received, we are expanding the exception to include situations where the compensation consultant's services are limited to providing information, such as surveys, that either is not customized for a particular company, or that is customized based on parameters that are not developed by the compensation consultant.[157] We are persuaded by commenters who noted that surveys that provide general information regarding the form and amount of compensation typically paid to executive officers and directors within a particular industry generally do not raise the potential conflicts of interest that the amendments are intended to address.[158] However, the exception would not be available if the compensation consultant provides advice or recommendations in connection with the information provided in the survey.

h. Other concerns

We did not propose, and do not at this time adopt, disclosure of consulting fees based on a percentage of revenues received from a company. We have considered the concern expressed by some commenters that compensation consultants, even if they are only retained by the board for executive compensation related services and do not provide any additional services to the company, may become overly reliant on a single client for revenues, which could affect the advice the consultant provides to the board.[159] However, we are not currently persuaded that such reliance would cause a consultant to provide advice to the board that inappropriately

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[157] See, e.g., letters from ABA, Mercer and Towers Perrin.

[158] See letters from Davis Polk and Mercer.

[159] See letters from Hewitt, Mercer, Pearl Meyer, and Towers Perrin.

reflects management's influence as a result of fees for additional services, which is the primary concern addressed by the final rule.

We also considered the suggestion provided by these commenters that companies be required to disclose various matters about the consideration of potential conflicts of interest.[160] We are not persuaded that we need to address this issue at this time and believe our final rule addresses our concerns without adding significant length to the disclosure or burdens on companies.

Our amendments as adopted are intended to facilitate investors' consideration of whether, in providing advice, a compensation consultant may have been influenced by a desire to retain other engagements from the company. This does not reflect a conclusion that we believe that a conflict of interest is present when disclosure is required under our new rule, or that a compensation committee or a company could not reasonably conclude that it is appropriate to engage a consultant that provides other services to the company requiring disclosure under our new rule. It also does not mean that we have concluded that there are no other circumstances that might present a conflict of interest for a compensation consultant retained by a compensation committee or company. Rather, the amendments are designed to provide context to investors in considering the compensation disclosures required to be provided under our rules, and, as explained above, are based on our understanding of the situations that are more likely to raise potential conflicts of interest concerns.

E. Reporting of Voting Results on Form 8-K

[160] In their comment letters, several multi-service compensation consulting firms proposed an alternative disclosure requirement. Under their proposal, if the total fees paid to the consultant for all services provided to the company and its affiliates during the preceding fiscal year exceeded one-half of one percent of the total revenues of the consultant for that fiscal year, the company would be required to disclose, among other things, the protocols established by the compensation committee to ensure that the consultant is able to provide unbiased advice and is not inappropriately influenced by the company's management. See letters from Hewitt, Mercer, Watson Wyatt, and Towers Perrin.

We proposed to transfer the requirement to disclose shareholder vote results from Forms 10-Q and 10-K to Form 8-K, and to have that information filed within four business days after the end of the meeting at which the vote was held. We are adopting the proposal with some modifications in response to comments.

1. Proposed Amendments

Currently, Item 4 in Part II of Form 10-Q and Item 4 in Form 10-K require the disclosure of the results of any matter that was submitted to a vote of shareholders during the fiscal quarter covered by either the Form 10-Q or Form 10-K with respect to the fourth fiscal quarter. The proposed amendments would delete this requirement from Forms 10-Q and 10-K and move it to Form 8-K. As a result, voting results would be required to be filed on Form 8-K within four business days after the end of the meeting at which the vote was held. To accommodate timing difficulties in contested elections, we proposed a new instruction to the form that stated that if the matter voted upon at the shareholders' meeting related to a contested election of directors and the voting results were not definitively determined at the end of the meeting, companies would be required to file the preliminary voting results within four business days after the preliminary voting results were determined, and then file an amended report on Form 8-K within four business days after the final voting results were certified.

2. Comments on the Proposed Amendments

The majority of comments we received on the proposed amendments supported requiring the filing of voting results on Form 8-K. Many commenters believed that more timely disclosure of the voting result would benefit shareholders and investors.[161] Some noted that matters submitted for shareholder vote involve issues that directly impact shareholder interests—for

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[161] See, e.g., letters from CalSTRS, CII, Hermes, IIA, Norges Bank, United Brotherhood of Carpenters and Walden.

example investment or divestments, changes in shareholder rights and capital changes—and that timely disclosure of voting results can be crucial.[162] One commenter believed that majority vote requirements for director elections have introduced greater accountability and uncertainty into uncontested director elections, making it increasingly important that these election outcomes be reported in a timely manner to shareholders.[163]

Several commenters recommended modifications to the proposed amendments. Specifically, some commenters expressed concern that preliminary voting results should not be required to be disclosed because disclosure of preliminary results could mislead investors if the definitive results reflect a different outcome than what was disclosed initially.[164] Concerns were also expressed that the reporting of preliminary voting results could inadvertently influence voting if the disclosure is made at a time when the opportunity remains open for additional votes to be cast.[165] Commenters also believed that the four business day reporting requirement should not be tied to the end of the shareholders' meeting, but rather to the issuance of a certified report of an inspector of election.[166] In addition, commenters suggested that the proposed instruction excepting the filing of voting results in contested elections of directors within four business days after the end of the shareholders' meeting should be expanded to cover any matter for which final voting results are not available or "too close to call" within four business days following the end of the shareholders' meeting.[167]

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[162] See, e.g., letters from CalSTRS and Norges Bank.

[163] See letter from United Brotherhood of Carpenters.

[164] See e.g., letter from Chadbourne.

[165] See letter from ABA.

[166] See letter from Allen Goolsby, et al.

[167] See, e.g., letters from BorgWarner, Business Roundtable, SCSG, S&C and Southern.

A few commenters opposed the proposed amendments.[168] Commenters opposed to amendments expressed concern that it would be very difficult to meet the four business day filing requirement. One of these commenters noted that problems that stem from share lending and other practices can significantly delay the time that votes can be tabulated.[169]

Several commenters believed that the disclosure of the results of shareholder votes should be added to the list of items on Form 8-K that are currently excluded from liability under Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, and that do not result in a loss of Form S-3 eligibility under General Instruction I.A.3(b).[170] One commenter, however, believed that an amendment to General Instruction I.A.3(b) of Form S-3 to add an exception to the Form S-3 eligibility requirements for the reporting of voting results would not be necessary if we allowed preliminary voting results for contested elections and on proposals that are "too close to call" to be reported within four business days of the meeting and final voting results within four business days after the voting results become final.[171]

3. Final Rule

After evaluating the comments received, we are adopting the proposed amendments to Form 8-K, and are eliminating the requirement to disclose shareholder voting results on Forms 10-Q and 10-K. Accordingly, new Item 5.07 to Form 8-K requires companies to disclose on the form the results of a shareholder vote and to have that information filed within four business days after the end of the meeting at which the vote was held. Tying the filing requirement to the end of the meeting will provide shareholders, investors and other users of this information with a

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[168] See, e.g., letters from Keith Bishop, NACD, RILA and SCC.

[169] See letter from NACD.

[170] See letters from ABA, Business Roundtable, Honeywell and S&C.

[171] See letter from SCSGP.

readily identifiable and certain date upon which a company would be required to disclose information on the results of the vote. We believe more timely disclosure of the voting results from an annual or special meeting would benefit investors and the markets. Under our prior disclosure requirements, it could be a few months before voting results are disclosed in a Form 10-Q or 10-K. Often, matters submitted for a shareholder vote at an annual or special meeting involve issues that directly impact shareholder interests, such as the election of directors, changes in shareholder rights, investments or divestments, and capital changes. The delay between the end of an annual or special meeting of shareholders and when the voting results of the meeting are disclosed in a Form 10-Q or 10-K can make the information less useful to investors and the markets. We also understand that technological advances in shareholder communications and the growing use of third-party proxy services have increased the ability of companies to tabulate vote results and disseminate this information on a more expedited basis.

We agree with the suggestions of commenters that there may be situations other than contested elections where it may take a longer period of time to determine definitive voting results.[172] As a result, we are expanding the instruction to Form 8-K as adopted to state that companies are required to file the preliminary voting results within four business days after the end of the shareholders' meeting, and then file an amended report on Form 8-K within four business days after the final voting results are known.[173] However, if a company obtains the definitive voting results before the preliminary voting results must be reported and decides to report its definitive results on Form 8-K, it will not be required to file the preliminary voting

[172] See, e.g., letters from Business Roundtable, S&C and Southern.

[173] See Instruction 1 to Item 5.07 of Form 8-K. We note that our amendments to Form 8-K are not intended to preclude a company from announcing preliminary voting results during the meeting of shareholders at which the vote was taken and before filing the Form 8-K, without regard to whether the company webcast the meeting.

results. For example, if a company obtains the definitive voting results two days after the end of the shareholders' meeting, it could report its definitive voting results on Form 8-K within four business days after the meeting and would not be required to file its preliminary voting results. To the extent that companies are concerned that the disclosure of preliminary voting results could be confusing to investors, they may include additional disclosure that helps to put the preliminary voting disclosure in a proper context.

In the Proposing Release, we requested comment on whether we should consider additional revisions to the requirement to report voting results, such as eliminating a portion of prior Instruction 4 to the disclosure item. One commenter responded by suggesting that we could consolidate and simplify some of the disclosure requirements and instructions to the item.[174] We agree with the suggestions that were submitted, and believe that certain requirements and instructions to the Item can be simplified, without changing the substance of what is required to be reported. Accordingly, we are adopting the following revisions to new Item 5.07:

- Adding to paragraph (a) of the item a statement that the information required by the item need be provided only when a meeting of shareholders is involved;[175]
- Combining paragraphs (b) and (c) to the item into a single paragraph that requires disclosure of the quantitative results of each matter voted on at the meeting, and a brief description of each matter; and
- Eliminating Instruction 3, Instruction 5 and Instruction 7 to the item, as well as deleting the first sentence of Instruction 4.

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[174] See letter of ABA.

[175] But see current Instruction 1 to Item 4 of Form 10-Q with respect to matters that have been submitted to a vote otherwise than at a meeting of shareholders, which we are not amending and which will be retained as Instruction 2 to new Item 5.07 of Form 8-K.

III. PAPERWORK REDUCTION ACT

A. Background

Certain provisions of the final amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[176] We published a notice requesting comment on the collection of information requirements in the proposing release for the rule amendments, and we submitted these requirements to the Office of Management and Budget ("OMB") for review in accordance with the PRA.[177] The titles for the collection of information are:

(1) "Regulation 14A and Schedule 14A" (OMB Control No. 3235-0059);

(2) "Regulation 14C and Schedule 14C" (OMB Control No. 3235-0057);

(3) "Form 10-K" (OMB Control No. 3235-0063);

(4) "Form 10-Q" (OMB Control No. 3235-0070);

(5) "Form 10" (OMB Control No. 3235-0064);

(6) "Form S-1" (OMB Control No. 3235-0065);

(7) "Form S-4" (OMB Control No. 3235-0324);

(8) "Form S-11" (OMB Control No. 3235-0067);

(9) "Form 8-K" (OMB Control No. 3235-0060);

(10) "Rule 20a-1 under the Investment Company Act of 1940, Solicitations of Proxies, Consents, and Authorizations" (OMB Control No. 3235-0158);

(11) "Form N-1A" (OMB Control No. 3235-0307);

(12) "Form N-2" (OMB Control No. 3235-0026);

(13) "Form N-3" (OMB Control No. 3235-0316); and

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[176] 44 U.S.C. 3501 et seq.

[177] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

(14) "Regulation S-K" (OMB Control No. 3235-0071).

The regulations, schedules and forms were adopted under the Securities Act and the Exchange Act, except for Forms N-1A, N-2, and N-3, which we adopted pursuant to the Securities Act and the Investment Company Act, and Rule 20a-1, which we adopted pursuant to the Investment Company Act. The regulations, forms and schedules set forth the disclosure requirements for periodic reports, registration statements, and proxy and information statements filed by companies to help investors make informed investment and voting decisions. The hours and costs associated with preparing, filing and sending the form or schedule 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 OMB control number. Compliance with the amendments is mandatory. Responses to the information collections will not be kept confidential and there is no mandatory retention period for the information disclosed.

B. Summary of the Final Rules

As discussed in more detail above, the amendments that we are adopting will require:

- To the extent that risks arising from a company's compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company, discussion of the company's compensation policies or practices as they relate to risk management and risk-taking incentives that can affect the company's risk and management of that risk;
- Reporting of the aggregate grant date fair value of stock awards and option awards granted in the fiscal year in the Summary Compensation Table and Director Compensation Table, computed in accordance with FASB ASC Topic 718, rather

than the dollar amount recognized for financial statement purposes for the fiscal year, with a special instruction for awards subject to performance conditions;

- New disclosure of the qualifications of directors and nominees for director, and the reasons why that person should serve as a director of the company at the time at which the relevant filing is made with the Commission;
- Additional disclosure of any directorships held by each director and nominee at any time during the past five years at any public company or registered management investment company;
- Additional disclosure of other legal actions involving a company's executive officers, directors, and nominees for director, and lengthening the time during which such disclosure is required from five to ten years;
- New disclosure regarding the consideration of diversity in the process by which candidates for director are considered for nomination by a company's nominating committee;
- New disclosure about a company's board leadership structure and the board's role in the oversight of risk;
- New disclosure about the fees paid to compensation consultants and their affiliates under certain circumstances; and
- Disclosure of the vote results from a meeting of shareholders on Form 8-K generally within four business days of the meeting.

The disclosure enhancements we are adopting will significantly improve the information companies provide to investors with regard to risk, governance and director qualifications and compensation. We believe that providing a more transparent view of these matters will help investors make more informed voting and investment decisions.

C. Summary of Comment Letters and Revisions to Proposals

In the Proposing Release, we requested comment on the PRA analysis. We received a response from one commenter that addressed our overall burden estimates for the proposed amendments. This commenter asserted that our PRA estimates underestimated the time and costs that companies would need to expend in complying with the proposed amendments.[178] This commenter asserted that companies would need to expend many additional hours to update their director and officer questionnaires to obtain more detailed information; director nominees would need to spend additional time responding to these questionnaires and providing companies with information about their backgrounds and qualifications; and companies would need to spend time analyzing the responses, deciding what information to disclose, and preparing the disclosures. This commenter, however, did not provide alternative cost estimates or cost estimates that could be applied generally to all companies. In response to comments and modifications to the amendments as proposed, we have revised our estimates as discussed more fully in Section D.

We have made several substantive modifications to the proposed amendments. First, new Item 402(s) of Regulation S-K requires a company to discuss its compensation policies and practices for employees if such policies and practices are reasonably likely to have a material adverse effect on the company. This change from the "may have a material effect" disclosure standard that was proposed should substantially mitigate some of the costs and burdens associated with the proposed amendments. By focusing on risks that are "reasonably likely to

[178] See letter from Business Roundtable.

have a material adverse effect" on the company, the amendments are designed to elicit disclosure on the company's compensation policies and practices that would be most relevant to investors. Second, we have adopted amendments to expand the list of legal proceedings involving directors, executive officers, and nominees covered under Item 401(f) of Regulation S-K. Third, disclosure will be required of whether (and if so, how) the nominating committee considers diversity in identifying nominees for director. Fourth, we have adopted a disclosure threshold under the compensation consultant disclosure amendments that excludes fee and related disclosure where the fees for non-executive compensation consulting services do not exceed $120,000 for a company's fiscal year. In addition, disclosure of fees for consultants engaged by management would not be required if the compensation committee or board has its own compensation consultant.

D. Revisions to PRA Reporting and Cost Burden Estimates

For purposes of the PRA, in the Proposing Release we estimated that the total annual increase in the paperwork burden for all companies (other than registered management investment companies) to prepare the disclosure that would be required under the proposed amendments would be approximately 247,773 hours of company personnel time and a cost of approximately $47,413,161 for the services of outside professionals. We further estimated the total annual increase in paperwork burden for registered management investment companies under the proposed amendments to be approximately 14,041 hours of company personnel time and a cost of approximately $7,048,900 for the services of outside professionals. As discussed above, we are revising the PRA burden and cost estimates that we originally submitted to the OMB in connection with the proposed amendments.

We derived our new burden hour and cost estimates by estimating the total amount of time it would take a company to prepare and review the disclosure requirements contained in the final rules. This estimate represents the average burden for all companies, both large and small. Our estimates have been adjusted to reflect the fact that some of the amendments would be required in some but not all of the documents listed above in Section A, and would not apply to all companies. In deriving our estimates, we recognize that the burdens will likely vary among individual companies based on a number of factors, including the size and complexity of their organizations, and the nature of their operations. We believe that some companies will experience costs in excess of this average in the first year of compliance with the amendments and some companies may experience less than the average costs. We estimate the annual incremental paperwork burden for all companies (other than registered management investment companies) to be approximately 223,426 hours of company personnel time and a cost of approximately $49,964,730 for the services of outside professionals. For registered management investment companies, we estimate the annual paperwork burden to be approximately 19,334 hours of company personnel time and a cost of approximately $9,480,200 for the services of outside professionals. These estimates include the time and the cost of preparing and reviewing disclosure, filing documents and retaining records.

With respect to reporting companies (other than registered management investment companies), the new rules and amendments will increase the existing disclosure burdens associated with proxy and information statements, Forms 10, 10-K, 8-K, S-1, S-4 and S-11. However, the disclosure requirements under new Item 402(s) of Regulation S-K are not applicable to smaller reporting companies.[179] With respect to registered management investment

[179] Based on the number of proxy filings we received in the 2008 fiscal year, we estimate that approximately 3,922 domestic companies are smaller reporting companies that have a public float of less than $75 million.

companies, the revisions will be reflected in certain Regulation S-K items, Schedule 14A, and Forms N-1A, N-2 and N-3.

In the Proposing Release, we assumed that the burden hours of the amendments would be comparable to the burden hours related to similar disclosure requirements under existing reporting requirements, such as the disclosure of audit fees and non-audit services,[180] CD&A and executive compensation reporting,[181] and the disclosure of the activities of nominating committees.[182] We have made several adjustments to these estimates to reflect the revisions we made to the amendments and the responses of commenters. We increased the burden estimate for the enhanced director and nominee disclosure by four hours to reflect the additional disclosures that will be required, such as the new legal proceedings and diversity policy, and to address concerns that our initial estimate may have been understated. At the same time, we have decreased the burden estimate related to new Item 402(s) of Regulation S-K from sixteen to eight hours, as well as the burden estimate related to the new compensation consultant disclosure from four to three hours to reflect the revisions to the proposed amendments. However, we made no change in our assumption that substantially all of the burdens associated with the amendments to Items 401 and 402 of Regulation S-K would be associated with Schedules 14A and 14C, as these would be the primary disclosure documents where the new disclosures would be prepared and presented.[183]

[180] Release No. 33-8183 (Jan. 28, 2003) [68 FR 6006] (which we estimated to be two hours).

[181] Release No. 33-8732A (Aug. 29, 2006) [71 FR 53518] (which we estimated to be 95 hours).

[182] Release No. 33-8340 (Nov. 24, 2003) [68 FR 69204] (which we estimated to be three hours).

[183] The burden estimates for Form 10-K assume that the amendments to Items 401 and 402 of Regulation S-K would be satisfied by either including the information directly in an annual report or incorporating the information by reference from the proxy statement or information statement on Schedule 14A or Schedule 14C. Our PRA estimates include an estimated 1 hour burden in the Form 10-K and schedules to account for the incorporation of the information that would be required under proposed amendments to Items 401 and 402 of Regulation S-K.

We made no change in our estimate that there would be no annual incremental increase in the paperwork burden for companies to comply with the amendments to the Summary Compensation Table, Director Compensation Table, and Grants of Plan-Based Awards Table. We believe that the amendments to the Summary Compensation Table, Grants of Plan-Based Awards Table and Director Compensation Table will simplify executive compensation disclosure because companies no longer will need to report two separate measures of equity compensation in their compensation disclosure. For purposes of Item 402 disclosure, companies no longer will need to explain or analyze a second, separate measure of equity compensation that is based on financial statement recognition rather than compensation decisions. In addition, we believe it is likely that these amendments will make companies' identification of named executive officers more consistent from year-to-year, providing investors more meaningful disclosure and reducing executive compensation tracking burdens in determining which executive officers are the most highly compensated.

We have added a special instruction for equity awards subject to performance conditions calling for tabular disclosure of the value computed based upon the probable outcome of the performance conditions as of the grant date. Because this value is already required to be computed under the accounting literature,[184] it will not impose an incremental increase in paperwork burden. This instruction also requires footnote disclosure of the maximum value assuming the highest level of performance conditions is probable. We believe that any incremental burden associated with providing this footnote disclosure would be minimal.

For each reporting company (other than registered management investment companies), we estimate that the amendments would impose on average the following incremental burden hours:

[184] FASB ASC Topic 718.

- Eight hours related to the amendments to discuss compensation policies and practices as they relate to risk management;
- Eight hours for the enhanced director and nominee disclosure;
- Six hours for the disclosures about board leadership structure and the board's role in risk oversight;
- Three hours for the disclosures regarding compensation consultants; and
- One hour for the reporting of voting results on Form 8-K rather than on Forms 10-Q and 10-K.

With respect to registered management investment companies, the amendments to Forms N-1A, N-2, and N-3 will increase existing disclosure burdens for such forms by requiring:

- New disclosure of the qualifications of directors and nominees for director, and the reasons why that person should serve as a director of the company at the time at which the relevant filing is made with the Commission;
- Additional disclosure of any directorships held by each director and nominee at any time during the past five years at public companies or registered management investment companies; and
- New disclosure about a fund's board leadership structure and the board's role in the oversight of risk.

We estimate that the amendments would impose on average the following incremental burden hours with respect to registered management investment companies:

- Eight hours for the enhanced director and nominee disclosure in proxy statements and six hours for such disclosure in registration statements;[185] and
- Six hours for the disclosures about company leadership structure and the board's role in risk management.

1. Proxy and Information Statements

For purposes of the PRA, in the case of reporting companies (other than registered management investment companies) we estimate the annual incremental paperwork burden for proxy and information statements under the amendments would be approximately seventeen hours per form for companies that are smaller reporting companies, and twenty-five hours per form for companies that are either accelerated or large accelerated filers. In the case of registered management investment companies, we estimate the annual incremental paperwork burden for proxy and information statements under the amendments would be approximately fourteen hours per form. These estimates include the time and the cost of preparing disclosure that has been appropriately reviewed by management, in-house counsel, outside counsel, and members of the board of directors.

2. Exchange Act Periodic Reports

For purposes of the PRA, we estimate the annual incremental paperwork burden for Form 10-K under the amendments would be approximately one hour per form. This estimate includes the time and the cost of preparing disclosure that has been appropriately reviewed by management, in-house counsel, outside counsel, and members of the board of directors.

[185] We estimate that the disclosure burden for registration statements on Forms N-1A, N-2, and N-3 is less than for proxy statements because the disclosures relating to involvement in legal proceedings for the past ten years applies only to proxy statements and not to registration statements.

3. Securities Act Registration Statements and Exchange Act Registration Statements

For purposes of the PRA, in the case of reporting companies (other than registered management investment companies) we estimate the annual incremental paperwork burden for Securities Act registration statements under the amendments would be approximately sixteen hours per form.[186] For registered management investment companies, we estimate that the annual incremental paperwork burden under the amendments to Forms N-1A, N-2, and N-3 would be approximately twelve hours per form. These estimates include the time and the cost of preparing disclosure that has been appropriately reviewed by management, in-house counsel, outside counsel, and members of the board of directors.

The tables below illustrate the total annual compliance burden of the collection of information in hours and in cost under the amendments for annual reports; quarterly reports; current reports; proxy and information statements; Form 10; Forms S-1, S-4, S-11, N-1A, N-2, and N-3; and Regulation S-K.[187] The burden estimates were calculated by multiplying the estimated number of responses by the estimated average amount of time it would take a company to prepare and review the disclosure requirements. For the Exchange Act reports on Forms 10-K, 10-Q, and 8-K, and the proxy and information statements we estimate that 75% of the burden of preparation is carried by the company internally and that 25% of the burden of preparation is carried by outside professionals retained by the company at an average cost of $400 per hour. For the registration statements on Forms 10, S-1, S-4, S-11, N-1A, N-2, and N-3, we estimate

[186] We calculated the sixteen hours by adding eight hours for the requirements under Item 402(s) of Regulation S-K to eight hours for the enhanced director and nominee disclosure.

[187] Figures in both tables have been rounded to the nearest whole number.

that 25% of the burden of preparation is carried by the company internally and that 75% of the burden of preparation is carried by outside professionals retained by the company at an average cost of $400 per hour. The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the company internally is reflected in hours. There is no change to the estimated burden of the collections of information under Regulation S-K because the burdens that this regulation imposes are reflected in our revised estimates for the forms.

Table 1. Incremental Paperwork Burden under the amendments for annual reports; quarterly reports; proxy and information statements:

	Number of Responses[188] (A)	Incremental Burden Hours/Form (B)	Total Incremental Burden Hours (C)=(A)*(B)	75% Company (D)=(C)*0.75	25% Professional (E)=(C)*0.25	Professional Costs (F)=(E)*$400
10-K	13,545	1	13,545	10,159	3,386	$1,354,500
10-Q[189]	32,462	(1)	(7,300)	(5,475)	(1,825)	$(730,000)
8-K[190]	117,255	1	117,255	87,941	29,314	$11,725,500
Sch. 14A[191]	7,300					
Accel. Filers	3,378	25	84,450	63,338	21,113	$8,445,000
SRC	3,922	17	66,674	50,006	16,669	$6,667,400

[188] The number of responses reflected in the table equals the actual number of forms and schedules filed with the Commission during the 2008 fiscal year, except for Form 8-K. The number of responses for Form 8-K reflects the number of Form 8-Ks filed during the 2008 fiscal year plus an additional 8,831 filings. See footnote 190 below.

[189] We calculated the reduction in the burden hours for Form 10-Q based on the number of proxy statements filed with the Commission during the 2008 fiscal year. We assumed that there would be, at a minimum, an equal number of Form 10-Qs filed to report the voting results from a meeting of shareholders. The reduction reflects the deletion of the disclosure of voting results from the form.

[190] We have included an additional 7,300 responses to Form 8-K to reflect the additional Form 8-Ks that would be filed to report final voting results. As explained in footnote 188 above, this number is based on the actual number of proxy statements filed in 2008. We adjusted this number upward by 20% to reflect our estimate of the additional Form 8-Ks that may be filed to report preliminary votes, and we have also included an additional 71 Form 8-Ks to reflect the number of Form 8-Ks that would be filed to report preliminary voting results because of a contested election, which we based on the actual number of proxy statements involving contested elections that were filed with the Commission during the 2008 fiscal year.

[191] The estimates for Schedule 14A and Schedule 14C are separated to reflect our estimate of the burden hours and costs related to new Item 402(s) of Regulation S-K which is applicable to companies that are either accelerated or large accelerated filers, but not applicable to companies that are non-accelerated filers, including smaller reporting companies. We estimate that 3,378 Schedule 14A responses were filed by accelerated or large accelerated filers, and 315 Schedule 14C responses were filed by accelerated or large accelerated filers.

Filers						
Sch. 14C	680					
Accel. Filers	315	25	7,867	5,900	1,967	$786,658
SRC Filers	365	17	6,211	4,658	1,553	$621,073
Rule 20a-1	1,225	14	17,150	12,863	4,288	$1,715,000
Reg. S-K	N/A	N/A	N/A	N/A	N/A	N/A
Total			305,851			$30,585,130

Table 2. Incremental Paperwork Burden under the amendments for registration statements:

	Number of Responses[192] (A)	Incremental Burden Hours/Form (B)	Total Incremental Burden Hours (C)=(A)*(B)	25% Company (D)=(C)*0.25	75% Professional (E)=(C)*0.75	Professional Costs (F)=(E)*$400
Form 10	238	16	3,809	952	2,856	$1,142,500
Form S-1	768	16	12,288	3,072	9,216	$11,579,500
Form S-4	619	16	9,904	2,476	7,428	$3,686,400
Form S-11	100	16	1,600	400	1,200	$2,971,200
Form N-1A	1,935	12	23,220	5,805	17,415	$6,966,000
Form N-2	205	12	2,460	615	1,845	$738,000
Form N-3	17	12	204	51	153	$61,200
Reg. S-K	N/A	N/A	N/A	N/A	N/A	N/A
Total			53,485			$27,144,800

IV. COST-BENEFIT ANALYSIS

A. Introduction

We are adopting amendments to enhance the disclosures with respect to a company's overall compensation policy and its impact on risk taking, director and nominee qualifications and legal proceedings, board leadership structure and the board's role in risk oversight, and the interests of compensation consultants. In addition, we are adopting amendments to transfer the requirement to disclose voting results from Forms 10-Q and 10-K to Form 8-K.

We also are adopting amendments to the disclosure requirements for executive and director compensation to require stock awards and option awards reporting based on a measure

[192] The number of responses reflected in the table equals the actual number of forms filed with the Commission during the 2008 fiscal year, except for Forms N-1A and N-3. The number of responses for Forms N-1A and N-3 reflect the number of open-ended management investment companies registered with the Commission as of the end of the 2008 fiscal year.

that will represent the aggregate grant date fair value of the compensation decision in the grant year, rather than the current rule, which allocates the grant date fair value over time commensurate with financial statement recognition of compensation costs.

B. Benefits

The amendments are intended to enhance transparency of a company's compensation policies and its impact on risk taking; director and nominee qualifications; board leadership structure and the role of the board in risk oversight; potential conflicts of interest of compensation consultants; and voting results at annual and special meetings.

1. Benefits Related to the New Narrative Disclosure of the Company's Compensation Policies and Practices as They Relate to the Company's Risk Management

Incentive arrangements and other compensation for employees may affect risk-taking behavior in the company's operations. To the extent that the risks arising from a company's compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company, investors will benefit through an enhanced ability to monitor it. They would also potentially benefit from the ability to use this additional information in allocating capital across companies, toward companies where employee incentives appear better aligned with operational success and investors' appetite for risk. The new disclosure may also encourage the board and senior management to examine and improve incentive structures for management and employees of the company. These benefits may also lead to increased value to investors.

2. Benefits Related to Revisions to Summary Compensation Table Disclosure

As a result of the Summary Compensation Table and Director Compensation Table amendments, companies will no longer need to prepare and report the allocation of equity awards' grant date fair value over time commensurate with financial statement recognition of compensation costs for executive and director compensation tabular reporting. Further, in preparing stock awards and option awards disclosure in the Summary Compensation Table and Director Compensation Table, companies no longer will need to incur additional costs to exclude the estimate for forfeitures related to service-based vesting used for financial statement reporting purposes. The elimination of costs of preparing and reporting this information is a benefit of the amendments.

The effects of the amendments in making information more readily available to investors may be useful to their voting and investment decisions. Reporting stock awards and option awards in the Summary Compensation Table based on aggregate grant date fair value is designed to make it easier for investors to assess compensation decisions and evaluate the decisions of the compensation committee. For example, under the amendments the Summary Compensation Table values will correspond to awards granted in the fiscal year, potentially allowing companies to better explain in CD&A how decisions with respect to awards granted for the year relate to other compensation decisions in the context of total compensation for the year. For awards subject to performance conditions, tabular disclosure will be based upon the probable outcome of the performance conditions as of the grant date. A special instruction for awards subject to performance conditions that requires footnote disclosure of the grant date fair value, assuming that the highest level of performance conditions will be achieved, will provide investors with further information as to the maximum potential payout of a particular grant. Further, the effect on total compensation of decisions to reprice options will be more evident because aggregate grant date fair value will be a component of total compensation reported in the Summary Compensation Table.

Under the amendments, the identification of named executive officers based on total compensation for the last completed fiscal year will reflect the aggregate grant date fair value of equity awards granted in that year. As a result, the named executive officers other than the principal executive officer and principal financial officer may change. Investors may benefit from receiving compensation disclosure with respect to executives who would not have been named executive officers under the former rules. To the extent that this change better aligns the identification of named executive officers with compensation decisions for the year, it should make it easier for companies to track executive compensation for reporting purposes.

Although the amendments are not intended to steer behavior, changes in the way that executive compensation is represented in the Summary Compensation Table and other new, compensation-related disclosures may indirectly lead boards to reconsider pay structure, potentially changing the amount of pay in some cases.

Smaller reporting companies are not required to provide a Grants of Plan-Based Awards Table or a CD&A, but are required to provide a Summary Compensation Table and Director Compensation Table. Investors in these companies should benefit from reporting stock awards and option awards based on aggregate grant date fair value in the grant year, as opposed to the current reporting approach based on financial statement recognition of the awards.

3. Benefits Related to Enhanced Director and Nominee Disclosure

The amendments to Item 401 of Regulation S-K, Schedule 14A and Forms N-1A, N-2 and N-3 will potentially benefit investors by increasing the amount and quality of information that they receive concerning the background and skills of directors and nominees for director, enabling investors to make better-informed voting and investment decisions. Disclosure of board's or other proponents' rationale for their nominees' membership on the board may benefit investors by enabling them to better assess whether and why a particular nominee is an appropriate choice for a particular company. Investors would be able to make more informed voting decisions in electing directors. Investors would also be able to adjust their holdings, allocating more capital to companies in which they believe board members are most likely to be able to effectively fulfill their duties to shareholders. In particular, in cases that do not meet investors' expectations, investors may respond by attempting to exert more influence on management or the board than would occur otherwise, thereby enhancing shareholder value.

Required disclosure of whether, and if so, how a nominating committee (or the board) considers diversity in connection with identifying and evaluating persons for consideration as nominees for a position on the board of directors may also benefit investors. Board diversity policy is an important factor in the voting decisions of some investors.[193] Such investors will directly benefit from diversity policy disclosure to the extent the policy and the manner in which it is implemented is not otherwise clear from observing past and current board selections. Although the amendments are not intended to steer behavior, diversity policy disclosure may also induce beneficial changes in board composition. A board may determine, in connection with preparing its disclosure, that it is beneficial to disclose and follow a policy of seeking diversity. Such a policy may encourage boards to conduct broader director searches, evaluating a wider range of candidates and potentially improving board quality. To the extent that boards branch out from the set of candidates they would ordinarily consider, they may nominate directors who have fewer existing ties to the board or management and are, consequently, more independent. To the extent that a more independent board is desirable at a particular company, the resulting increase in board independence could potentially improve governance. In addition,

[193] See, e.g., letters from Calvert, Trillium, Boston Common Asset Management, CII, Florida State Board of Administration, and Sisters of Charity BVM. See also letter from Lissa Lamkin Broome and Thomas Lee Hazen.

in some companies a policy of increasing board diversity may also improve the board's decision-making process by encouraging consideration of a broader range of views.

Expanded disclosure of membership on previous corporate boards may also benefit investors by making it easier for them to evaluate whether nominees' past board memberships present potential conflicts of interest (such as membership on boards of major suppliers, customers, or competitors). Investors may also be able to more easily evaluate the performance, in both operations and governance, of the other companies on whose boards the nominees serve or have served. The public may also benefit from better understanding any potential positive or negative effects on corporate performance resulting from directors serving on other boards.

The expanded list of legal proceedings involving directors, nominees and executive officers that must be disclosed, as well as the expanded disclosure of these legal proceedings from the current five-year requirement to ten years, would benefit investors by providing more information by which they could determine the suitability of a director or nominee.

4. Benefits Related to New Disclosure about Board Leadership Structure and the Board's Role in Risk Oversight

Investors may benefit from new disclosure about board leadership structure. In particular, they may benefit from understanding management's explanation regarding whether or not the principal executive officer serves as chairman of the board and, in the case of a registered management investment company, whether the chairman is an "interested person" of the fund. In deciding whether to separate principal executive officer and chairman positions, companies may consider several factors, including the effectiveness of communication with the board and the degree to which the board can exercise independent judgment about management performance, and shareholders may, in different cases, be best served by different decisions. Although the amendments are not intended to drive behavior, there may be possible benefits if a company re-evaluates its leadership structure or the board's role in risk oversight and decides to make changes as a result.

Disclosures of the board's role in risk oversight may also benefit investors. Expanded disclosure of the board's role in risk oversight may enable investors to better evaluate whether the board is exercising appropriate oversight of risk. Investors would be able to adjust their holdings, allocating more capital to companies in which they believe the board is adequately focused on risks. Improved capital allocation will also benefit the financial markets by increasing market efficiency.

5. Benefits Related to New Disclosure Regarding Compensation Consultants

New disclosure regarding compensation consultants may benefit investors by illuminating potential conflicts of interest. Providing better, more complete information in cases where the value of non-executive compensation services is over $120,000 for the last fiscal year will allow investors to determine for themselves whether there are concerns related to the compensation consultants' financial interests and objectivity. Compensation consultants may earn fees from other services to the company, including benefits administration, human resources consulting, and actuarial services. With an incentive to retain these significant additional revenue streams, they may face incentives to cater, to some degree, to management preferences in recommending executive compensation packages.[194] The House Committee on Oversight and Government Reform's Study on Executive Pay documented that 113 of 250 of the largest publicly traded companies hired compensation consultants that earned fees from other services, and that this practice was positively correlated with higher CEO pay.[195] However, Cadman,

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[194] See letter from Mary Ellen Carter.

[195] In December 2007, the U.S. House of Representatives Committee on Oversight and Government Reform issued a report on the role played by compensation consultants at large, publicly-traded companies (the "Waxman Report").

Carter and Hilligeist (2009) studied a larger set of companies, but did not find statistically significant relations between certain factors thought to indicate conflicts of interest and the level of CEO pay.[196] To the degree that these potential conflicts may be more transparent under the amendments, investors benefit through their ability to better monitor the process of setting executive pay. This potential conflict is substantially reduced when the compensation committee hires a compensation consultant that does not provide other services to the company. Benefits of the amendment may be limited to the degree that compensation consultants have other potential conflicts of interest not specifically enumerated in the amendments.

Disclosures about compensation consultants may have effects on competition in the compensation consulting industry, introducing potential relative costs and benefits to both multi-service consulting firms and consulting firms exclusively specializing in executive compensation. Specific potential effects on competition are discussed in Section V below. Broadly, the disclosures may affect the level of competition in the compensation consulting industry. Any increase in competition could reduce prices of consulting services, benefiting client companies. Changes in competition may also affect the content of advice provided to companies. As discussed more fully in Section C below, it is possible that, if the level of competition in the industry decreases, compensation consultants may be less inclined to make recommendations favorable to management. This could potentially benefit shareholders.

The Waxman Report found that the fees earned by compensation consultants for providing other services often far exceed those earned for advising on executive compensation, and that on average companies paid compensation consultants over $2.3 million for other services and less than $220,000 for executive compensation advice. See Staff of House Comm. on Oversight and Government Reform, 110th Cong., Report on Executive Pay: Conflicts of Interest Among Compensation Consultants (Comm. Print 2007).

[196] Cadman, Carter and Hilligeist, 2009, The Incentives of Compensation Consultants and CEO Pay, Journal of Accounting and Economics (forthcoming) and provided with the letter submitted by Mary Ellen Carter.

6. Benefits Related to Reporting of Voting Results on Form 8-K

The amendments to Form 8-K will facilitate security holder access to faster disclosure of the vote results of a company's annual or special meeting. To find this information, investors no longer would need to wait for this information to be disclosed in a Form 10-Q or 10-K, which could be filed months after the end of the meeting.

C. Costs

The amendments will impose new disclosure requirements on companies. Some of the disclosures are designed to build upon existing requirements to elicit a more detailed discussion of director and nominee qualifications, legal proceedings, and the interests of compensation consultants. To the degree that the amendments require collecting information currently available, costs related to information collection will be limited.

1. Costs Related to the New Narrative Disclosure of the Company's Compensation Policies and Practices as They Relate to the Company's Risk Management

We believe that there may be information gathering costs associated with the new disclosure of the company's compensation policies and practices as they relate to the company's risk management, even though the information required may be readily available, because this information may need to be reported up from business units and analyzed. Some commenters noted that the amendments would require companies to incur additional costs, such as costs related to conducting a risk analysis of compensation policies for all employees.[197] This could also include the cost of hiring additional advisors to assist in the analysis, as well as additional costs in drafting the new disclosure. Using our PRA burden estimates, we estimate the aggregate

[197] See, e.g., letters from Business Roundtable and Robert Ahrenholz.

annual cost of the amendments to be approximately $12,215,326.[198] As previously discussed, the proposed amendments would have required discussion and analysis of compensation policies if risks arising from those compensation policies "may have a material effect on the company." We have revised the amendment to require a company to discuss its compensation policies and practices for employees if such policies and practices are "reasonably likely to have a material adverse effect" on the company. By focusing on risks that are "reasonably likely to have a material adverse effect" on the company, we believe the amendments will result in a smaller number of companies making this risk disclosure. This change from the "may have a material effect" disclosure should mitigate some of the costs and burdens associated with the amendments.

Companies may also face costs related to the disclosure of the company's compensation policies to the extent that it provides management with incentives to adopt risk-averse strategies that result in the abandonment of risky projects whose returns otherwise would compensate for the amount of additional risk. This could discourage beneficial risk-taking behavior.

2. Costs Related to Revisions to Summary Compensation Table Disclosure

Investors may face some costs related to revisions in executive compensation reporting. Under the amendments to the Summary Compensation Table and as noted in the Benefits section, the identification of named executive officers based on total compensation for the last completed fiscal year will reflect the aggregate grant date fair value of equity awards granted in that year, so that some executives subject to executive compensation disclosure may be different.

[198] This estimate is based on the estimated total burden hours of the amendments associated with the schedules and forms that would include the new disclosure, an assumed 75%/25% split of the burden hours between internal staff and external professionals with respect to proxy and information statements, an assumed 25%/75% split of the burden hours between internal staff and external professionals with respect to registration statements, and an hourly rate of $200 for internal staff time and $400 for external professionals.

Smaller reporting companies, which are not required to provide the Grants of Plan-Based Awards Table, may incur some costs on a transitional basis in switching from the previously required measure of stock awards and option awards to aggregate grant date fair value reporting. We expect that any such additional costs will be limited by the fact that grant date fair value information required under the amendments is also collected to comply with financial reporting purposes. Because companies other than smaller reporting companies previously were required to report the grant date fair value of individual equity awards in the Grants of Plan-Based Awards Table, we expect that they will incur only negligible costs in switching to the amended Summary Compensation Table and Director Compensation Table disclosure requirements.

Moreover, grant date fair value guidelines under FASB ASC Topic 718 call for management to exercise judgment in valuing stock options. For financial statement recognition purposes, the grant date fair value measure of compensation cost is expensed over the expected term of the option. Compensation cost for awards containing a performance-based vesting condition is recognized only if it is probable that the performance condition will be achieved. To the extent that an investor believes that Summary Compensation Table and Director Compensation Table disclosure of stock awards and option awards should be measured based on financial statement recognition principles to take into account potential adjustments, the amendments may entail a cost. The special instruction for awards subject to performance conditions mitigates this potential cost to some extent by providing that such awards are reported in the Summary Compensation Table and Director Compensation Table based upon the probable outcome of the performance condition(s) as of the grant date. This instruction also requires footnote disclosure of the maximum value assuming the highest level of performance conditions is probable. We believe that any incremental cost associated with providing this footnote disclosure would be minimal.

3. Costs Related to Enhanced Director and Nominee Disclosure

Companies may face some information gathering and reporting costs related to enhanced director and nominee disclosure. One commenter noted that companies may face costs related to the amendments to the extent that companies will need to update their director and officer questionnaires to obtain more detailed information, and will need to spend additional time analyzing the information as well as preparing the disclosures.[199] Companies may also experience increased costs as it may be more difficult to find candidates willing to serve on boards if they do not want this information disclosed in a Commission filing. To the extent that information is available and verifiable through other sources, however, we expect the potential costs of the additional disclosure will be limited. Using our PRA burden estimates, we estimate the aggregate annual cost to operating companies to be approximately $20,790,000.[200] With respect to our PRA burden estimates for registered management investment companies, we estimate the aggregate annual cost to be approximately $6,979,700.[201]

In addition, although the amendments are not intended to steer behavior, a company may adopt a diversity policy in connection with preparing its disclosure regarding whether and, if so, how diversity is considered in connection with identifying and evaluating persons for

[199] See letter from Business Roundtable.

[200] This estimate is based on the estimated total burden hours of the amendments associated with the schedules and forms that would include the new disclosures, an assumed 75%/25% split of the burden hours between internal staff and external professionals with respect to proxy and information statements, an assumed 25%/75% split of the burden hours between internal staff and external professionals with respect to registration statements, and an hourly rate of $200 for internal staff time and $400 for external professionals.

[201] This estimate is based on the estimated total burden hours of 22,742, an assumed 75%/25% split of the burden hours between internal staff and external professionals with respect to proxy statements, an assumed 25%/75% split of the burden hours between internal staff and external professionals with respect to registration statements, and an hourly rate of $200 for internal staff time and $400 for external professionals.

consideration as nominees for a position on the board of directors. If this policy turns out to be difficult to implement, companies could incur economic costs as a result in the form of recruiting costs or otherwise.

4. Costs Related to New Disclosure about Board Leadership Structure and the Board's Role in Risk Oversight

Companies may face some costs related to new disclosure about board leadership structure. Disclosure of the board's role in risk oversight may have some similar costs. The information gathering costs are likely to be less significant than the costs to prepare the disclosure. Using our PRA burden estimates, we estimate the aggregate annual cost to operating companies to be approximately $11,970,000.[202] With respect to our PRA burden estimates for registered management investment companies, we estimate the aggregate annual cost to be approximately $6,367,200.[203] Although the amendments are not intended to drive behavior, there may be possible costs if a company re-evaluates its leadership structure or the board's role in risk oversight and decides to make changes as a result.

5. Costs Related to New Disclosure Regarding Compensation Consultants

Companies may face some costs related to new disclosure about fees for compensation consulting and for other services provided by compensation consultants. Using our PRA burden estimates, we estimate the aggregate annual cost to be approximately $5,985,000.[204] In addition,

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[202] This estimate is based on the estimated total burden hours of the amendments associated with the schedules and forms that would include the new disclosures, an assumed 75%/25% split of the burden hours, and an hourly rate of $200 for internal staff time and $400 for external professionals.

[203] This estimate is based on the estimated total burden hours of 20,292, an assumed 75%/25% split of the burden hours between internal staff and external professionals with respect to proxy statements, an assumed 25%/75% split of the burden hours between internal staff and external professionals with respect to registration statements, and an hourly rate of $200 for internal staff time and $400 for external professionals.

[204] This estimate is based on the estimated total burden hours related to the amendments in connection to Schedules 14A and 14C, an assumed 75%/25% split of the burden hours, and an hourly rate of $200 for internal staff time and $400 for external professionals.

the costs to a company in contracting with compensation consultants could be increased under these amendments, and compensation consultants also may alter their mix of services. For instance, costs may increase if companies decide to contract with multiple compensation consultants for services that had previously been provided by only one compensation consultant. Several commenters asserted that the amendments could discourage companies from using a single compensation consulting firm to provide executive compensation services and services other than executive compensation consulting.[205] Possible increased costs might include the costs associated with the time each new compensation consultant will need to learn about the company and the decline in any economies of scale the compensation consultant may have factored into fees charged to the company. To the extent that compensation consulting firms exit compensation consulting to eliminate potential conflicts and mandatory fee disclosure, fewer experienced consultants may be available for hire. To the extent that the remaining consultants cannot scale operations sufficiently quickly to meet demand, then this could result in less qualified opinions from remaining consultants, with potential costs to shareholders. In the long run, however, industry capacity may increase, which would mitigate this effect.

Disclosures on compensation consultants may have effects on competition in the compensation consulting industry, introducing potential relative costs and benefits to multi-service consulting firms and consulting firms specializing in executive compensation. Specific potential effects on competition are discussed in the Section V below. As discussed in more detail in Section V, competition could conceivably decrease if some multi-service firms exit the executive compensation consulting industry. Any decrease in competition could increase prices of consulting services, potentially creating higher costs for client companies, while benefiting the compensation consulting industry as a whole. However, competition could increase, for

[205] See, e.g., letters from Mercer, Towers Perrin and Watson Wyatt.

example, to the extent that the amendments make smaller boutique firms more attractive to companies. If the amendments increase competitiveness of the industry, compensation consultants may charge lower fees. They may also, however, feel pressure to generate recommendations favorable to management in order to increase the likelihood of being retained in the future. Any decline in the objectivity of advice from compensation consultants would potentially be costly to shareholders.

6. Costs Related to Reporting of Voting Results on Form 8-K

Shareholders who are used to receiving this information in a Form 10-Q filing may incur costs of adapting their research practices to find this information in Form 8-K filings, which may involve searching through a number of filings. This adjustment may involve costs, in particular, to those investors who process this information using automated systems. A separate filing to report the information and potentially report both preliminary and final voting results may also increase direct costs to companies for filing fees, filing creation, and report dissemination because it may require two Form 8-K filings. However, the cost for preparing a quarterly report on Form 10-Q would be less because this disclosure would not appear in that Form. Companies that report preliminary voting results may face some additional information gathering and reporting costs because they would need to file a Form 8-K to disclose preliminary voting results and to file an amended Form 8-K to disclose final vote results. Using our PRA burden estimates, we estimate the aggregate annual cost to be approximately $2,207,750.[206]

[206] This estimate is based on the estimated 8,831 additional Form 8-K filings, an assumed 75%/25% split of one burden hour between internal staff and external professionals, and an hourly rate of $200 for internal staff time and $400 for external professionals.

V. CONSIDERATION OF IMPACT ON THE ECONOMY, BURDEN ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 23(a)(2) of the Exchange Act requires us,[207] when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Section 2(b) of the Securities Act,[208] Section 3(f) of the Exchange Act,[209] and Section 2(c) of the Investment Company Act require us,[210] when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

The amendments that we are adopting are designed to enhance the information companies provide to investors with regard to the following:

- Risk: by requiring disclosure about the board's role in oversight of risk and, to the extent that risks arising from a company's compensation policies and practices are reasonably likely to have a material adverse effect on the company, disclosure about such policies and practices as they relate to risk management;
- Governance and Director Qualifications: by requiring expanded disclosure of the background and qualifications of directors and director nominees and new disclosure

[207] 15 U.S.C. 78w(a)(2).

[208] 15 U.S.C. 77b(b).

[209] 15 U.S.C. 78c(f).

[210] 15 U.S.C. 80a-2(c).

about a company's board leadership structure, and accelerating the reporting of information regarding shareholder voting results; and

- Compensation: by revising the reporting of stock and option awards received by named executive officers, and requiring disclosure of potential conflicts of interest of compensation consultants in certain circumstances.

The amendments are designed to enable investors to make better informed voting and investment decisions. For example, several commenters noted that investors will be able to use the new risk disclosures to make more informed investment decisions.[211] Improved investment decisions could lead to increased efficiency and competitiveness of the U.S. capital markets. Investors could allocate capital across companies, toward companies where the risk incentives are more aligned with an investor's risk preference. In this regard, the amendments may affect the relative ability of some companies to raise capital depending on how investors react to the disclosures they provide in response to the amendments. In addition, the amendments may improve the efficiency of information gathering by investors to the extent that disclosure provided in response to the amendments is easier to access through filings made with the Commission.

The amendments may affect competition, such as encouraging competition among companies to demonstrate superior risk oversight and improved incentive structures for management and the employees of the company. Several commenters indicated that the amendments requiring fee and other disclosures related to compensation consultants might have some effects on competition among firms in this industry. Some of these commenters believed the amendments could negatively impact competition among large multi-service compensation

[211] See, e.g., letters from CalSTRS, CII, the General Board of Pension and Health Benefits of the United Methodist Church, and Hermes.

consulting firms.[212] Companies will face new disclosure requirements with respect to their use of compensation consulting firms in certain circumstances, but not with respect to compensation consulting firms who provide only executive compensation consulting services. To the extent that companies receiving compensation consulting services are reluctant to disclose the fees paid for advice on executive compensation, this may put some larger multi-service compensation consulting firms at a competitive disadvantage relative to smaller firms who focus on executive compensation consulting. In such cases, multi-service firms may be excluded from competing for compensation consulting services at companies where they already provide other non-executive compensation consulting services. However, this potential anti-competitive impact may be diminished to the extent that the potential opportunities lost to some multi-service firms would otherwise be available to other multi-service firms who do not provide non-executive compensation consulting services to the company. To the extent that this occurs, competition between multi-service firms could increase. In addition, the amendments provide a limited exception to the disclosure requirements for fees paid to other compensation consultants retained by the company if the board has retained its own consultant that reports to the board. This exception limits disclosure to circumstances that are more likely to present conflicts of interest, which should also address concerns about the competitive disadvantage faced by multi-service firms.

In some instances, the amendments may result in disclosure of pricing information that certain compensation consulting firms would prefer to remain private, which could affect some consulting firms' marginal cost of providing executive compensation and non-executive compensation services. Competition in the compensation consulting industry also may be

[212] See, e.g., letters from Hewitt, Mercer and Towers Perrin.

affected if, for example, some compensation consulting firms choose not to provide executive compensation consulting services to avoid having to disclose fees on other, more critical aspects of their businesses. If multi-service compensation consulting firms currently use cross-selling synergies to subsidize their compensation consulting services for the purpose of soliciting other business, then their departure may result in an increase in fees, which may better approximate the stand-alone value of the services and promote competition from new market participants who could not otherwise subsidize compensation consulting services.

Conversely, the amendments may increase competition in the executive compensation consulting industry. If certain larger compensation consulting firms currently enjoy an advantage related to their ability to cross sell services, for example, where management is more likely to recommend to the board a compensation consultant with whom management has prior experience, the marginal cost of providing services may be lower, currently, than it is for smaller compensation consulting firms. In this circumstance, any additional marginal costs related to disclosure by multi-service firms may have the effect of making marginal costs faced by multi-service firms and boutique firms more equal, allowing boutique firms to compete more effectively. This may encourage entry into compensation consulting services by more firms, or at least make the threat of their entry more credible. If the number of multi-service compensation consulting firms is limited, relative to potential entrants, the level of effective competition in the industry may increase. The industry may also become more competitive for other reasons. For example, more public availability of aggregate fee disclosure, in general, may provide an informational advantage to companies as they negotiate with potential compensation consulting firms, effectively lowering the price of consulting services. Additionally, pricing disclosed, either publicly or in private negotiation, may more accurately reflect each particular service provided. If multi-service compensation consulting firms currently use cross-selling synergies to subsidize their compensation consulting services for the purpose of soliciting other business, then an increase in fees resulting from their departure may better approximate the stand-alone value of the services and promote competition from new market participants who could not otherwise subsidize compensation consulting services.

The size of the market for compensation consulting services is large; depending on the assumptions, we estimate that the total fee revenues of the compensation consulting market could be in the range of $480 million to $3.7 billion. The lower approximate bound is calculated using the $200,000 average per firm fee for executive compensation advice paid by the 250 large companies studied in the Waxman Report, and an estimated 2,190 companies from the Russell 3000 index that report using an executive compensation consultant.[213] The lower estimate could be higher to the extent that non-Russell 3000 companies also hire compensation consultants, or lower to the extent that smaller companies pay less than $200,000 for compensation consulting advice. The upper approximate bound is calculated from the periodic reports of the four largest multi-service compensation consulting firms: Towers Perrin, Mercer, Hewitt, and Watson Wyatt. These four firms reported 2008 fiscal year-end total revenues of $9.9 billion, of which $2.16 billion was disclosed as generated from compensation consulting activities, but which could include non-executive compensation consulting services.[214] Considering that these four firms

[213] See letter from Mary Ellen Carter.

[214] Hewitt reported 33% of total revenues ($990 million) from Talent and Organizational Consulting; Mercer reported $550 million in consulting revenue from management and rewarding of employees, the design of remuneration programs, and improvement of human resource effectiveness; Watson Wyatt reported 10% of total revenues ($167 million) from its Human Capital Group, which included providing advice on compensation plans and other long-term incentive programs; Towers Perrin reported 26.6% of total revenues ($450 million) from Talent and Rewards Consulting.

represent approximately 58% of the compensation consulting market,[215] this indicates the total compensation consulting market could be $3.7 billion.

VI. FINAL REGULATORY FLEXIBILITY ANALYSIS

This Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with the Regulatory Flexibility Act.[216] This FRFA relates to amendments to Regulation S-K, Schedule 14A and Forms 8-K, 10-Q, and 10-K under the Exchange Act, and Forms N-1A, N-2, and N-3, under the Investment Company Act. The amendments will require the following:

- To the extent that risks arising from a company's compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company, discussion of the company's compensation policies or practices as they relate to risk management and risk-taking incentives that can affect the company's risk and management of that risk;
- Reporting of the aggregate grant date fair value of stock awards and option awards granted in the fiscal year in the Summary Compensation Table and Director Compensation Table to be computed in accordance with FASB ASC Topic 718, with a special instruction for awards subject to performance conditions;
- New disclosure of the qualifications of directors and nominees for director, and the reasons why that person should serve as a director of the company at the time at which the relevant filing is made with the Commission; the same information would be required with respect to directors nominated by others;

[215] See letter from Mary Ellen Carter.

[216] 5 U.S.C. 601.

- Additional disclosure of any directorships held by each director and nominee at any time during the past five years at any public company or registered investment company;
- Additional disclosure of other legal actions involving a company's executive officers, directors, and nominees for director, and lengthening the time during which such disclosure is required from five to ten years;
- New disclosure about a company's board leadership structure and the board's role in the oversight of risk;
- New disclosure regarding the consideration of diversity in the process by which candidates for director are considered for nomination by a company's nominating committee;
- New disclosure about the fees paid to compensation consultants and their affiliates under certain circumstances; and
- Reporting of the vote results from a meeting of shareholders on Form 8-K generally within four business days of the meeting.

An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance with the Regulatory Flexibility Act and included in the Proposing Release.

A. Need for the Amendments

As described both in this release and the Proposing Release, during the past few years, investors have increasingly focused on corporate accountability, and have expressed the desire for additional information that would enhance their ability to make informed voting and investment decisions. The amendments are intended to improve the disclosure shareholders of public companies receive regarding compensation and corporate governance, and facilitate communications relating to voting decisions. We believe the amendments will enhance the transparency of a company's compensation policies and practices, and the impact of such policies and practices on risk taking; director and nominee qualifications; board leadership structure; the potential conflicts of compensation consultants; and will provide investors with clearer and more meaningful executive compensation disclosure.

B. Significant Issues Raised by Public Comments

In the Proposing Release, we requested comment on any aspect of the IRFA, including the number of small entities that would be affected by the proposed amendments, the nature of the impact, how to quantify the number of small entities that would be affected, and how to quantify the impact of the proposed amendments. We did not receive comments specifically addressing the IFRA. However, several commenters addressed aspects of the proposed rule amendments that could potentially affect small entities. In particular, some commenters believed that compliance with the proposed amendments would impose a significant burden on smaller companies.[217] Other commenters believed that smaller companies should be exempted from all or parts of the amendments.[218] Although we believe that a complete exemption from the amendments would not be appropriate because this would interfere with achieving the goal of enhancing the information provided to all investors, we have made revisions to the amendments that we believe will significantly reduce the impact of the amendments on reporting companies, including smaller companies. In addition, we did not propose, and we are not at this time adopting, a requirement that smaller companies discuss their compensation policies and practices

[217] See letters from Keith Bishop and Theragenics.

[218] See, e.g., letters from the Committee on Securities Law of the Business Law Section of the Maryland State Bar Association and Theragenics.

for employees if such policies and practices are reasonably likely to have a material adverse effect.

C. Small Entities Subject to the Final Amendments

The amendments will affect some companies that are small entities. The Regulatory Flexibility Act defines "small entity" to mean "small business," "small organization," or "small governmental jurisdiction."[219] The Commission's rules define "small business" and "small organization" for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by the Commission. Securities Act Rule 157[220] and Exchange Act Rule 0-10(a)[221] defines a company, other than an investment company, to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. We estimate that there are approximately 1,229 companies, other than registered investment companies, that may be considered small entities. The amendments to Regulation S-K, Schedule 14A and Forms 8-K, 10-Q, and 10-K will affect any small entity that is subject to Exchange Act periodic and proxy reporting requirements. In addition, the amendments also will affect small entities that file a registration statement under the Securities Act.

An investment company is considered to be a "small business" if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[222] We believe that the amendments will affect small entities that are investment companies. We estimate that there are approximately 162 investment companies that may be considered small entities.

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[219] 5 U.S.C. 601(6).

[220] 17 CFR 230.157.

[221] 17 CFR 240.0-10(a).

[222] 17 CFR 270.0-10(a).

D. Reporting, Recordkeeping, and other Compliance Requirements

The amendments are designed to enhance the transparency of boards of directors, provide investors with a better understanding of the functions and activities of boards, and to provide investors with clearer and more meaningful compensation disclosure. These amendments will require small entities that are operating companies to provide:

- Reporting stock awards and option awards in the Summary Compensation Table and Director Compensation Table based on aggregate grant date fair value;
- Disclosure of the qualifications of directors and nominees for director, and a brief discussion of the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director for the company at the time the disclosure is made, in light of the company's business and structure;
- Additional disclosure concerning certain legal proceedings involving a company's directors, nominees for director and executive officers;
- Disclosure regarding the consideration of diversity in the process by which candidates for director are considered for nomination by a company's nominating committee;
- Additional disclosure, in certain instances, about compensation consultants retained by the board of directors; and
- Disclosure of the results of shareholder votes on Form 8-K generally within four business days after the end of the meeting.

In addition, these amendments would require small entities that are registered management investment companies to provide:

- Disclosure of the qualifications of directors and nominees for director, and the reasons why that person should serve as a director of the company at the time at which the relevant filing is made with the Commission;
- Disclosure of any directorships held by each director and nominee at any time during the past five years at public companies or registered management investment companies; and
- Disclosure about a fund's board leadership structure and the board's role in the oversight of risk.

E. Agency Action to Minimize Effect on Small Entities

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

- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- Clarifying, consolidating or simplifying compliance and reporting requirements under the rules for small entities;
- Using performance rather than design standards; and
- Exempting small entities from all or part of the requirements.

In connection with the amendments, we considered alternatives, including establishing different compliance or reporting requirements that take into account the resources available to small entities, clarifying or simplifying compliance and reporting requirements under the amendments for small entities, using design rather than performance standards, and exempting small entities from all or part of the amendments.

Under our current rules, small entities are subject to some different compliance or reporting requirements under Regulation S-K, and the amendments do not alter these requirements. Under Regulation S-K, small entities are required to provide abbreviated compensation disclosure with respect to the principal executive officer and two most highly compensated executive officers for the last two completed fiscal years. Specifically, small entities may provide the executive compensation disclosure specified in Items 402(l) through (r) of Regulation S-K, rather than the corresponding disclosure specified in Items 402(a) through (k) of Regulation S-K. Items 402(l) through (r) also do not require small entities to provide CD&A or the Grants of Plan-Based Awards Table. The amendments to the Summary Compensation Table and Director Compensation Table are unlikely to have a significant impact on small entities because their principal effect is to disclose stock and option awards based on grant-date fair value, which small entities need to compute for financial reporting purposes. We did not propose, and we are not adopting, a requirement that smaller companies discuss their compensation policies and practices for employees if such policies and practices are reasonably likely to have a material adverse effect. In addition, the amendments to the Grants of Plan-Based Awards Table do not apply to small entities.

We considered, but did not establish additional different compliance requirements for small entities. We believe that investors in companies that are small entities may want and would benefit from the disclosures elicited by the amendments regarding director and nominee qualifications, as well as board leadership and risk oversight. For example, many commenters noted that our amendments to enhance director and nominee disclosure would provide investors with additional information that would allow them to make better informed investment and voting decisions.[223] Different compliance requirements or an exemption for small entities would interfere with achieving the goal of enhancing the information provided to all investors. We believe that uniform and comparable disclosures across all companies will help investors and the markets.

We also considered, but did not establish, different disclosure thresholds for small entities under our amendments regarding compensation consultant disclosure. Although the disclosure exclusion provided in the amendment where the fees for non-executive compensation consulting services do not exceed $120,000 for a company's fiscal year will reduce the compliance burdens for all companies, we believe this change will likely be more meaningful to companies that are small entities because these companies likely expend a lesser amount of their revenues on compensation consulting services.

The amendments clarify, consolidate and simplify the reporting requirements for all public companies including small entities. The amendments require clear and straightforward disclosure of director and nominee qualifications, board leadership structure and the potential conflicts of interest of compensation consultants. We have used a mix of design and performance standards in connection with the amendments. Based on our past experience, we believe the amendments will be more useful to investors if there are specific disclosure requirements, however, some of the new requirements provide companies flexibility in determining what information to disclose. The disclosures are intended to result in more comprehensive and clearer disclosure.

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[223] See, e.g., letters from Board of Directors Network, Forum of Executive Women, Integrated Governance Solutions, and Norges Bank.

VII. STATUTORY AUTHORITY AND TEXT OF THE AMENDMENTS

The amendments contained in this release are being adopted under the authority set forth in Sections 3(b), 6, 7, 10, and 19(a) of the Securities Act; Sections 12, 13, 14, 15(d) and 23(a) of the Exchange Act; and Sections 8, 20(a), 24(a), 30 and 38 of the Investment Company Act.

List of Subjects

17 CFR Parts 229, 239, 240, 249 and 274

Reporting and recordkeeping requirements, Securities.

TEXT OF THE AMENDMENTS

For the reasons set out in the preamble, the Commission amends title 17, chapter II, of the Code of Federal Regulations as follows:

PART 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, 777iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a), 80a-39, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Amend §229.401 by:

a. revising paragraph (e)(1);

b. in paragraph (e)(2) revising the phrase "Indicate any other directorships" to read "Indicate any other directorships held, including any other directorships held during the past five years,";

c. in paragraph (f), introductory text, revising the phrase "during the past five years" to read "during the past ten years";

d. removing the word "or" following the semi-colon at the end of paragraph (f)(4);

e. removing the period at the end of paragraphs (f)(5) and (f)(6) and adding in their place a semi-colon;

f. adding paragraphs (f)(7) and (f)(8) before the Instructions to paragraph (f);

g. in the Instruction 1 to paragraph (f) revise the phrase "For purposes of computing the five year period" to read "For purposes of computing the ten-year period"; and

h. adding Instruction 5 to the Instructions to paragraph (f).

The revisions and additions read as follows:

§229.401 (Item 401) Directors, executive officers, promoters and control persons.

* * * * *

(e) Business experience. (1) Background. Briefly describe the business experience during the past five years of each director, executive officer, person nominated or chosen to become a director or executive officer, and each person named in answer to paragraph (c) of Item 401, including: each person's principal occupations and employment during the past five years; the name and principal business of any corporation or other organization in which such occupations and employment were carried on; and whether such corporation or organization is a parent, subsidiary or other affiliate of the registrant. In addition, for each director or person nominated or chosen to become a director, briefly discuss the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director for the registrant at the time that the disclosure is made, in light of the registrant's business and structure. If material, this disclosure should cover more than the past five years, including information about the person's particular areas of expertise or other relevant qualifications. When an executive officer or person named in response to paragraph (c) of Item 401 has been employed by the registrant or a subsidiary of the registrant for less than five years, a brief explanation shall be included as to the nature of the responsibility undertaken by the individual in prior positions to provide adequate disclosure of his or her prior business experience. What is required is information relating to the level of his or her professional competence, which may include, depending upon the circumstances, such specific information as the size of the operation supervised.

* * * * *

(f) * * *

(7) Such person was the subject of, or a party to, any Federal or State judicial or administrative order, judgment, decree, or finding, not subsequently reversed, suspended or vacated, relating to an alleged violation of:

(i) Any Federal or State securities or commodities law or regulation; or

(ii) Any law or regulation respecting financial institutions or insurance companies including, but not limited to, a temporary or permanent injunction, order of disgorgement or restitution, civil money penalty or temporary or permanent cease-and-desist order, or removal or prohibition order; or

(iii) Any law or regulation prohibiting mail or wire fraud or fraud in connection with any business entity; or

(8) Such person was the subject of, or a party to, any sanction or order, not subsequently reversed, suspended or vacated, of any self-regulatory organization (as defined in Section 3(a)(26) of the Exchange Act (15 U.S.C. 78c(a)(26))), any registered entity (as defined in Section 1(a)(29) of the Commodity Exchange Act (7 U.S.C. 1(a)(29))), or any equivalent exchange, association, entity or organization that has disciplinary authority over its members or persons associated with a member.

<u>Instructions to Paragraph (f) of Item 401</u>:

* * * * *

5. This paragraph (f)(7) shall not apply to any settlement of a civil proceeding among private litigants.

* * * * *

3. Amend §229.402 by:

a. revising paragraphs (c)(2)(v) and (c)(2)(vi), and paragraph (c)(2)(ix)(G);

b. removing the Instruction to Item (c)(2)(v) and (vi), and adding in its place Instructions 1, 2, and 3 to Item (c)(2)(v) and (vi) before paragraph (c)(2)(vii);

c. removing the period at the end of paragraphs (d)(2)(iii) and (d)(2)(iv) and adding a semi-colon in their place;

d. adding Instruction 8 to Item 402(d);

e. revising paragraphs (k)(2)(iii) and (k)(2)(iv);

f. revising paragraph (k)(2)(vii)(I) and Instruction to Item 402(k);

g. in paragraph (l) revising the phrase "paragraphs (a) through (k)" to read "paragraphs (a) through (k) and (s)";

h. revising paragraphs (n)(2)(v) and (n)(2)(vi);

i. removing the Instruction to Item 402(n)(2)(v) and (vi), and adding in its place Instructions 1, 2, and 3 to Item 402(n)(2)(v) and (vi) before paragraph (n)(2)(vii);

j. revising paragraph (n)(2)(ix)(G);

k. revising paragraphs (r)(2)(iii), (r)(2)(iv) and (r)(2)(vii)(I), and Instruction to Item 402(r); and

l. adding paragraph (s) before the Instructions to Item 402.

The revisions and additions read as follows:

§229.402 (Item 402) Executive compensation.

* * * * *

(c) * * *

(2) * * *

(v) For awards of stock, the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (e));

(vi) For awards of options, with or without tandem SARs (including awards that subsequently have been transferred), the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (f));

<u>Instruction 1 to Item 402(c)(2)(v) and (vi)</u>. For awards reported in columns (e) and (f), include a footnote disclosing all assumptions made in the valuation by reference to a discussion of those assumptions in the registrant's financial statements, footnotes to the financial statements, or discussion in the Management's Discussion and Analysis. The sections so referenced are deemed part of the disclosure provided pursuant to this Item.

<u>Instruction 2 to Item 402(c)(2)(v) and (vi)</u>. If at any time during the last completed fiscal year, the registrant has adjusted or amended the exercise price of options or SARs previously

awarded to a named executive officer, whether through amendment, cancellation or replacement grants, or any other means ("repriced"), or otherwise has materially modified such awards, the registrant shall include, as awards required to be reported in column (f), the incremental fair value, computed as of the repricing or modification date in accordance with FASB ASC Topic 718, with respect to that repriced or modified award.

Instruction 3 to Item 402(c)(2)(v) and (vi). For any awards that are subject to performance conditions, report the value at the grant date based upon the probable outcome of such conditions. This amount should be consistent with the estimate of aggregate compensation cost to be recognized over the service period determined as of the grant date under FASB ASC Topic 718, excluding the effect of estimated forfeitures. In a footnote to the table, disclose the value of the award at the grant date assuming that the highest level of performance conditions will be achieved if an amount less than the maximum was included in the table.

* * * * *

(ix) * * *

(G) The dollar value of any dividends or other earnings paid on stock or option awards, when those amounts were not factored into the grant date fair value required to be reported for the stock or option award in column (e) or (f); and

* * * * *

(d) * * *

Instructions to Item 402(d).

* * * * *

8. For any equity awards that are subject to performance conditions, report in column (l) the value at the grant date based upon the probable outcome of such conditions. This amount

should be consistent with the estimate of aggregate compensation cost to be recognized over the service period determined as of the grant date under FASB ASC Topic 718, excluding the effect of estimated forfeitures.

* * * * *

(k) * * *

(2) * * *

(iii) For awards of stock, the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (c));

(iv) For awards of options, with or without tandem SARs (including awards that subsequently have been transferred), the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (d));

* * * * *

(vii) * * *

(I) The dollar value of any dividends or other earnings paid on stock or option awards, when those amounts were not factored into the grant date fair value required to be reported for the stock or option award in column (c) or (d); and

* * * * *

<u>Instruction to Item 402(k)</u>. In addition to the Instruction to paragraphs (k)(2)(iii) and (iv) and the Instructions to paragraph (k)(2)(vii) of this Item, the following apply equally to paragraph (k) of this Item: Instructions 2 and 4 to paragraph (c) of this Item; Instructions to paragraphs (c)(2)(iii) and (iv) of this Item; Instructions to paragraphs (c)(2)(v) and (vi) of this Item; Instructions to paragraph (c)(2)(vii) of this Item; Instructions to paragraph (c)(2)(viii) of this Item; and Instructions 1 and 5 to paragraph (c)(2)(ix) of this Item. These Instructions apply

to the columns in the Director Compensation Table that are analogous to the columns in the Summary Compensation Table to which they refer and to disclosures under paragraph (k) of this Item that correspond to analogous disclosures provided for in paragraph (c) of this Item to which they refer.

* * * * *

(n) * * *

(2) * * *

(v) For awards of stock, the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (e));

(vi) For awards of options, with or without tandem SARs (including awards that subsequently have been transferred), the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (f));

<u>Instruction 1 to Item 402(n)(2)(v) and (n)(2)(vi)</u>. For awards reported in columns (e) and (f), include a footnote disclosing all assumptions made in the valuation by reference to a discussion of those assumptions in the smaller reporting company's financial statements, footnotes to the financial statements, or discussion in the Management's Discussion and Analysis. The sections so referenced are deemed part of the disclosure provided pursuant to this Item.

<u>Instruction 2 to Item 402(n)(2)(v) and (n)(2)(vi)</u>. If at any time during the last completed fiscal year, the smaller reporting company has adjusted or amended the exercise price of options or SARs previously awarded to a named executive officer, whether through amendment, cancellation or replacement grants, or any other means ("repriced"), or otherwise has materially modified such awards, the smaller reporting company shall include, as awards required to be

reported in column (f), the incremental fair value, computed as of the repricing or modification date in accordance with FASB ASC Topic 718, with respect to that repriced or modified award.

<u>Instruction 3 to Item 402(n)(2)(v) and (vi)</u>. For any awards that are subject to performance conditions, report the value at the grant date based upon the probable outcome of such conditions. This amount should be consistent with the estimate of aggregate compensation cost to be recognized over the service period determined as of the grant date under FASB ASC Topic 718, excluding the effect of estimated forfeitures. In a footnote to the table, disclose the value of the award at the grant date assuming that the highest level of performance conditions will be achieved if an amount less than the maximum was included in the table.

*   *   *   *   *

(ix) * * *

(G) The dollar value of any dividends or other earnings paid on stock or option awards, when those amounts were not factored into the grant date fair value required to be reported for the stock or option award in column (e) or (f); and

*   *   *   *   *

(r) * * *

(2) * * *

(iii) For awards of stock, the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (c));

(iv) For awards of options, with or without tandem SARs (including awards that subsequently have been transferred), the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (d));

*   *   *   *   *

(vii) * * *

(I) The dollar value of any dividends or other earnings paid on stock or option awards, when those amounts were not factored into the grant date fair value required to be reported for the stock or option award in column (c) or (d); and

* * * * *

Instruction to Item 402(r). In addition to the Instruction to paragraph (r)(2)(vii) of this Item, the following apply equally to paragraph (r) of this Item: Instructions 2 and 4 to paragraph (n) of this Item; the Instructions to paragraphs (n)(2)(iii) and (iv) of this Item; the Instructions to paragraphs (n)(2)(v) and (vi) of this Item; the Instructions to paragraph (n)(2)(vii) of this Item; the Instruction to paragraph (n)(2)(viii) of this Item; the Instructions to paragraph (n)(2)(ix) of this Item; and paragraph (o)(7) of this Item. These Instructions apply to the columns in the Director Compensation Table that are analogous to the columns in the Summary Compensation Table to which they refer and to disclosures under paragraph (r) of this Item that correspond to analogous disclosures provided for in paragraph (n) of this Item to which they refer.

* * * * *

(s) Narrative disclosure of the registrant's compensation policies and practices as they relate to the registrant's risk management. To the extent that risks arising from the registrant's compensation policies and practices for its employees are reasonably likely to have a material adverse effect on the registrant, discuss the registrant's policies and practices of compensating its employees, including non-executive officers, as they relate to risk management practices and risk-taking incentives. While the situations requiring disclosure will vary depending on the particular registrant and compensation policies and practices, situations that may trigger disclosure include, among others, compensation policies and practices: at a business unit of the company that carries a significant portion of the registrant's risk profile; at a business unit with compensation structured significantly differently than other units within the registrant; at a business unit that is significantly more profitable than others within the registrant; at a business unit where compensation expense is a significant percentage of the unit's revenues; and that vary significantly from the overall risk and reward structure of the registrant, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the registrant from the task extend over a significantly longer period of time. The purpose of this paragraph (s) is to provide investors material information concerning how the registrant compensates and incentivizes its employees that may create risks that are reasonably likely to have a material adverse effect on the registrant. While the information to be disclosed pursuant to this paragraph (s) will vary depending upon the nature of the registrant's business and the compensation approach, the following are examples of the issues that the registrant may need to address for the business units or employees discussed:

(1) The general design philosophy of the registrant's compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices, as such policies and practices relate to or affect risk taking by employees on behalf of the registrant, and the manner of their implementation;

(2) The registrant's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation;

(3) How the registrant's compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring claw backs or imposing holding periods;

(4) The registrant's policies regarding adjustments to its compensation policies and practices to address changes in its risk profile;

(5) Material adjustments the registrant has made to its compensation policies and practices as a result of changes in its risk profile; and

(6) The extent to which the registrant monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees.

* * * * *

4. Amend §229.407 by:

a. revising paragraph (c)(2)(vi);

b. revising paragraph (e)(3)(iii); and

c. adding paragraph (h) before the Instructions to Item 407.

The revisions and additions read as follows:

§229.407 (Item 407) Corporate governance.

* * * * *

(c) * * *

(2) * * *

(vi) Describe the nominating committee's process for identifying and evaluating nominees for director, including nominees recommended by security holders, and any differences in the manner in which the nominating committee evaluates nominees for director based on whether the nominee is recommended by a security holder, and whether, and if so how, the nominating committee (or the board) considers diversity in identifying nominees for director. If the nominating committee (or the board) has a policy with regard to the consideration of diversity in identifying director nominees, describe how this policy is implemented, as well as how the nominating committee (or the board) assesses the effectiveness of its policy;

*   *   *   *   *

(e) *   *   *

(3) *   *   *

(iii) Any role of compensation consultants in determining or recommending the amount or form of executive and director compensation (other than any role <u>limited</u> to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees; or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice) during the registrant's last completed fiscal year, identifying such consultants, stating whether such consultants were engaged directly by the compensation committee (or persons performing the equivalent functions) or any other person, describing the nature and scope of their assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement:

(A) If such compensation consultant was engaged by the compensation committee (or persons performing the equivalent functions) to provide advice or recommendations on the amount or form of executive and director compensation (other than any role <u>limited</u> to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees; or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice) and the compensation consultant or its affiliates also provided additional services to the registrant or its affiliates in an amount in excess of $120,000 during the registrant's last completed fiscal year, then disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for such additional services. Disclose whether the decision to engage the compensation consultant or its affiliates for these other services was made, or recommended, by management, and whether the compensation committee or the board approved such other services of the compensation consultant or its affiliates.

(B) If the compensation committee (or persons performing the equivalent functions) has not engaged a compensation consultant, but management has engaged a compensation consultant to provide advice or recommendations on the amount or form of executive and director compensation (other than any role <u>limited</u> to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees; or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice) and such compensation consultant or its affiliates has provided additional services to the registrant in an amount in excess of $120,000 during the registrant's last completed fiscal year, then disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for any additional services provided by the compensation consultant or its affiliates.

* * * * *

(h) Board leadership structure and role in risk oversight. Briefly describe the leadership structure of the registrant's board, such as whether the same person serves as both principal executive officer and chairman of the board, or whether two individuals serve in those positions, and, in the case of a registrant that is an investment company, whether the chairman of the board is an "interested person" of the registrant as defined in section 2(a)(19) of the Investment Company Act (15 U.S.C. 80a-2(a)(19)). If one person serves as both principal executive officer and chairman of the board, or if the chairman of the board of a registrant that is an investment company is an "interested person" of the registrant, disclose whether the registrant has a lead independent director and what specific role the lead independent director plays in the leadership of the board. This disclosure should indicate why the registrant has determined that its leadership structure is appropriate given the specific characteristics or circumstances of the registrant. In addition, disclose the extent of the board's role in the risk oversight of the registrant, such as how the board administers its oversight function, and the effect that this has on the board's leadership structure.

* * * * *

PART 239 — FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

5. 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.

* * * * *

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

6. The authority citation for Part 240 is revised to read 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 and 12 U.S.C. 5221(e)(3) unless otherwise noted.

* * * * *

7. Amend §240.14a-101 by:

a. revising paragraph (b) of Item 7;

b. in Item 22:

i. redesignating paragraph (b)(3) as paragraph (b)(3)(ii);

ii. adding new paragraph (b)(3)(i); and

iii. redesignating Instruction to paragraph (b)(3) as Instruction to paragraph (b)(3)(ii);

iv. redesignating paragraph (b)(4), introductory text, and paragraph (b)(4)(i) through paragraph (b)(4)(iv) as new paragraph (b)(4)(i), introductory text, and paragraph (b)(4)(i)(A) through paragraph (b)(4)(i)(D);

v. adding new paragraph (b)(4)(ii); and

vi. revising paragraph (b)(11) before the Instruction.

The revisions and additions read as follows:

§240.14a-101 Schedule 14A. Information required in proxy statement.

* * * * *

Item 7. Directors and executive officers.

* * * * *

(b) The information required by Items 401, 404(a) and (b), 405 and 407(d)(4), (d)(5) and (h) of Regulation S–K (§229.401, §229.404(a) and (b), §229.405 and §229.407(d)(4), (d)(5) and (h) of this chapter).

* * * * *

<u>Item 22.</u> <u>Information required in investment company proxy statement</u>.

* * * * *

(b) <u>Election of Directors</u>. * * *

(3)(i) For each director or nominee for election as director, briefly discuss the specific experience, qualifications, attributes, or skills that led to the conclusion that the person should serve as a director for the Fund at the time that the disclosure is made in light of the Fund's business and structure. If material, this disclosure should cover more than the past five years, including information about the person's particular areas of expertise or other relevant qualifications.

* * * * *

(4) * * *

(ii) Unless disclosed in the table required by paragraph (b)(1) of this Item or in response to paragraph (b)(4)(i) of this Item, indicate any directorships held during the past five years by each director or nominee for election as director in any company with a class of securities registered pursuant to section 12 of the Exchange Act (15 U.S.C. 78l) or subject to the requirements of section 15(d) of the Exchange Act (15 U.S.C. 78o(d)) or any company registered as an investment company under the Investment Company Act of 1940 (15 U.S.C. 80a-1 <u>et seq.</u>), as amended, and name the companies in which the directorships were held.

* * * * *

(11) Provide in tabular form, to the extent practicable, the information required by Items 401(f) and (g), 404(a), 405, and 407(h) of Regulation S-K (§§229.401(f) and (g), 229.404(a), 229.405, and 229.407(h) of this chapter).

Instruction to paragraph 22(b)(11). Information provided under paragraph (b)(8) of this Item 22 is deemed to satisfy the requirements of Item 404(a) of Regulation S-K for information about directors, nominees for election as directors, and Immediate Family Members of directors and nominees, and need not be provided under this paragraph (b)(11).

PART 249 -- FORMS, SECURITIES EXCHANGE ACT OF 1934

8. The authority citation for part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a et seq. and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

9. Amend Form 8-K (referenced in §249.308) by adding Item 5.07 under the caption "Information to Be Included in the Report" after the General Instructions read as follows:

Note: The text of Form 8-K does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 8-K

* * * * *

General Instructions

* * * * *

Information to Be Included in the Report

* * * * *

Item 5.07 Submission of Matters to a Vote of Security Holders.

If any matter was submitted to a vote of security holders, through the solicitation of proxies or otherwise, provide the following information:

(a) The date of the meeting and whether it was an annual or special meeting.

(b) If the meeting involved the election of directors, the name of each director elected at the meeting, as well as a brief description of each other matter voted upon at the meeting; and state the number of votes cast for, against or withheld, as well as the number of abstentions and broker non-votes as to each such matter, including a separate tabulation with respect to each nominee for office.

(c) A description of the terms of any settlement between the registrant and any other participant (as defined in Instruction 3 to Item 4 of Schedule 14A (17 CFR 240.14a-101)) terminating any solicitation subject to Rule 14a-12(c), including the cost or anticipated cost to the registrant.

Instruction 1 to Item 5.07. The four business day period for reporting the event under this Item 5.07 shall begin to run on the day on which the meeting ended. The registrant shall disclose on Form 8-K under this Item 5.07 the preliminary voting results. The registrant shall file an amended report on Form 8-K under this Item 5.07 to disclose the final voting results within four business days after the final voting results are known. However, no preliminary voting results need be disclosed under this Item 5.07 if the registrant has disclosed final voting results on Form 8-K under this Item.

Instruction 2 to Item 5.07. If any matter has been submitted to a vote of security holders otherwise than at a meeting of such security holders, corresponding information with respect to such submission shall be provided. The solicitation of any authorization or consent (other than a proxy to vote at a stockholders' meeting) with respect to any matter shall be deemed a submission of such matter to a vote of security holders within the meaning of this item.

Instruction 3 to Item 5.07. If the registrant did not solicit proxies and the board of directors as previously reported to the Commission was re-elected in its entirety, a statement to that effect in answer to paragraph (b) will suffice as an answer thereto.

Instruction 4 to Item 5.07. If the registrant has furnished to its security holders proxy soliciting material containing the information called for by paragraph (c), the paragraph may be answered by reference to the information contained in such material.

Instruction 5 to Item 5.07. If the registrant has published a report containing all the information called for by this item, the item may be answered by a reference to the information contained in such report.

* * * * *

10. Amend Form 10-Q (referenced in §249.308a) by removing Item 4 in Part II—Other Information, and redesignating Items 5 and 6 as Items 4 and 5.

11. Amend Form 10-K (referenced in §249.310) by removing Item 4 in Part I, and redesignating Items 5 through 15 as Items 4 through 14.

Note: The text of Forms 10-Q and 10-K do not, and these amendments will not, appear in the Code of Federal Regulations.

PART 239 — FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

PART 274 — FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

12. The authority citation for Part 274 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

* * * * *

13. Form N-1A (referenced in §§239.15A and 274.11A), Item 17 is amended by:

a. revising the heading to paragraph (b);

b. revising paragraph (b)(1);

c. redesignating paragraph (b)(3), introductory text, and paragraph (b)(3)(i) through paragraph (b)(3)(iv) as paragraph (b)(3)(i), introductory text, and paragraph (b)(3)(i)(A) through paragraph (b)(3)(i)(D);

d. adding new paragraph (b)(3)(ii); and

e. adding paragraph (b)(10).

The revisions and additions read as follows:

Note: The text of Form N-1A does not, and these amendments will not, appear in the Code of Federal Regulations.

Form N-1A

* * * * *

Item 17. Management of the Fund

* * * * *

(b) Leadership Structure and Board of Directors.

(1) Briefly describe the leadership structure of the Fund's board, including the responsibilities of the board of directors with respect to the Fund's management and whether the chairman of the board is an interested person of the Fund. If the chairman of the board is an interested person of the Fund, disclose whether the Fund has a lead independent director and what specific role the lead independent director plays in the leadership of the Fund. This disclosure should indicate why the Fund has determined that its leadership structure is appropriate given the specific characteristics or circumstances of the Fund. In addition, disclose

the extent of the board's role in the risk oversight of the Fund, such as how the board administers its oversight function and the effect that this has on the board's leadership structure.

* * * * *

(3) * * *

(ii) Unless disclosed in the table required by paragraph (a)(1) of this Item 17 or in response to paragraph (b)(3)(i) of this Item 17, indicate any directorships held during the past five years by each director in any company with a class of securities registered pursuant to section 12 of the Securities Exchange Act (15 U.S.C. 78l) or subject to the requirements of section 15(d) of the Securities Exchange Act (15 U.S.C. 78o(d)) or any company registered as an investment company under the Investment Company Act, and name the companies in which the directorships were held.

* * * * *

(10) For each director, briefly discuss the specific experience, qualifications, attributes, or skills that led to the conclusion that the person should serve as a director for the Fund at the time that the disclosure is made, in light of the Fund's business and structure. If material, this disclosure should cover more than the past five years, including information about the person's particular areas of expertise or other relevant qualifications.

* * * * *

14. Form N-2 (referenced in §§239.14 and 274.11a-1), Item 18 is amended by:

a. redesignating paragraph 5, introductory text, and paragraph 5(a) through paragraph 5(d) as paragraph 5(b), introductory text, and paragraph 5(b)(1) through paragraph 5(b)(4);

b. adding new paragraph 5(a);

c. redesignating paragraph 6, introductory text, and paragraph 6(a) through paragraph 6(d) as paragraph 6(a), introductory text, and paragraph 6(a)(1) through paragraph 6(a)(4);

d. adding new paragraph 6(b); and

e. adding paragraph 17 after the instructions.

The additions read as follows:

Note: The text of Form N-2 does not, and these amendments will not, appear in the Code of Federal Regulations.

Form N-2

* * * * *

Item 18. Management

* * * * *

5.(a) Briefly describe the leadership structure of the Registrant's board, including whether the chairman of the board is an interested person of the Registrant, as defined in section 2(a)(19) of the 1940 Act (15 U.S.C. 80a-2(a)(19)). If the chairman of the board is an interested person of the Registrant, disclose whether the Registrant has a lead independent director and what specific role the lead independent director plays in the leadership of the Registrant. This disclosure should indicate why the Registrant has determined that its leadership structure is appropriate given the specific characteristics or circumstances of the Registrant. In addition, disclose the extent of the board's role in the risk oversight of the Registrant, such as how the board administers its oversight function, and the effect that this has on the board's leadership structure.

* * * * *

6. * * *

(b) Unless disclosed in the table required by paragraph 1 of this Item 18 or in response to paragraph 6(a) of this Item 18, indicate any directorships held during the past five years by each director in any company with a class of securities registered pursuant to section 12 of the Exchange Act (15 U.S.C. 78l) or subject to the requirements of section 15(d) of the Exchange Act (15 U.S.C. 78o(d)) or any company registered as an investment company under the 1940 Act, and name the companies in which the directorships were held.

* * * * *

17. For each director, briefly discuss the specific experience, qualifications, attributes, or skills that led to the conclusion that the person should serve as a director for the Registrant at the time that the disclosure is made, in light of the Registrant's business and structure. If material, this disclosure should cover more than the past five years, including information about the person's particular areas of expertise or other relevant qualifications.

* * * * *

15. Form N-3 (referenced in §§239.17a and 274.11b), Item 20 is amended by:

a. redesignating paragraph (d), introductory text, and paragraph (d)(i) through paragraph (d)(iv) as paragraph (d)(ii), introductory text, and paragraph (d)(ii)(A) through paragraph (d)(ii)(D);

b. adding new paragraph (d)(i);

c. redesignating paragraph (e), introductory text, and paragraph (e)(i) through paragraph (e)(iv) as paragraph (e)(i), introductory text, and paragraph (e)(i)(A) through paragraph (e)(i)(D);

d. adding new paragraph (e)(ii); and

e. adding paragraph (o) after the instructions.

The additions read as follows:

Note: The text of Form N-3 does not, and these amendments will not, appear in the Code of Federal Regulations.

Form N-3

* * * * *

Item 20. Management

* * * * *

(d)(i) Briefly describe the leadership structure of the Registrant's board, including whether the chairman of the board is an interested person of the Registrant, as defined in Section 2(a)(19) of the 1940 Act (15 U.S.C. 80a-2(a)(19)) and the rules thereunder. If the chairman of the board is an interested person of the Registrant, disclose whether the Registrant has a lead independent director and what specific role the lead independent director plays in the leadership of the Registrant. This disclosure should indicate why the Registrant has determined that its leadership structure is appropriate given the specific characteristics or circumstances of the Registrant. In addition, disclose the extent of the board's role in the risk oversight of the Registrant, such as how the board administers its risk oversight function, and the effect that this has on the board's leadership structure.

(e) * * *

(ii) Unless disclosed in the table required by paragraph (a) of this Item 20 or in response to paragraph (e)(i) of this Item 20, indicate any directorships held during the past five years by each director in any company with a class of securities registered pursuant to section 12 of the Exchange Act (15 U.S.C. 78l) or subject to the requirements of Section 15(d) of the Exchange Act (15 U.S.C. 78o(d)) or any company registered as an investment company under the 1940 Act, and name the companies in which the directorships were held.

* * * * *

(o) For each director, briefly discuss the specific experience, qualifications, attributes, or skills that led to the conclusion that the person should serve as a director for the Registrant at the time that the disclosure is made, in light of the Registrant's business and structure. If material, this disclosure should cover more than the past five years, including information about the person's particular areas of expertise or other relevant qualifications.

* * * * *

By the Commission.

Florence E. Harmon

Florence E. Harmon
Deputy Secretary

December 16, 2009

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT of 1933
Release No. 9090 / December 16, 2009

SECURITIES EXCHANGE ACT of 1934
Release No. 61182 / December 16, 2009

In the Matter of **Investools Inc.,** **Respondent.**	**ORDER UNDER SECTION 27A(b) OF THE SECURITIES ACT OF 1933 AND SECTION 21E(b) OF THE SECURITIES EXCHANGE ACT OF 1934, GRANTING WAIVERS OF THE DISQUALIFICATION PROVISIONS OF SECTION 27A(b)(1)(A)(ii) OF THE SECURITIES ACT OF 1933 AND SECTION 21E(b)(1)(A)(ii) OF THE SECURITIES EXCHANGE ACT OF 1934 AS TO INVESTOOLS INC. AND ITS AFFILIATES**

Investools Inc. ("Investools") has submitted a letter on behalf of itself and any of its current and future affiliates, dated November 18, 2009, requesting a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 ("Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") arising from its settlement of an injunctive action filed by the Commission.

On December 10, 2009, the Commission filed a civil injunctive action in the United States District Court for the District of Columbia, alleging that Investools is liable as a controlling person under Section 20(a) of the Exchange Act for violations by its employees of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5. In its complaint, the Commission alleged that certain Investools sales personnel committed fraud during sales presentations at workshops that Investools held throughout the United States. The complaint further alleged that, from 2004 to approximately June 2007, Investools failed to adequately supervise its sales personnel. The complaint alleged that, during that time, Investools management learned that certain of its speakers were claiming, at investor workshops, that their securities trading was tremendously profitable. The complaint also alleged that Investools never required its speakers to provide it with documentation substantiating their trading success claims, such as brokerage account statements or tax forms. On December 16, 2009, pursuant to Investools' consent, the United States District Court for the District of Columbia entered a Final Judgment permanently enjoining Investools from violating, directly or indirectly, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder [15 U.S.C. §78j(b); 17 C.F.R. §240.10b-5].

The safe harbor provisions of Section 27A(c) of the Securities Act and Section 21E(c) of the Exchange Act are not available for any forward looking statement that is "made with respect to the business or operations of an issuer, if the issuer . . . during the 3-year period preceding the date on which the statement was first made . . . has been made the subject of a judicial or administrative decree or order arising out of a governmental action that (I) prohibits future violations of the antifraud provisions of the federal securities laws; (II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or (III) determines that the issuer violated the antifraud provisions of the securities laws[.]" Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act. The disqualifications may be waived "to the extent otherwise specifically provided by rule, regulation, or order of the Commission." Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act.

Based on the representations set forth in Investools' letter, the Commission has determined that, under the circumstances, the request for a waiver of the disqualifications resulting from the entry of the Final Judgment is appropriate and should be granted.

Accordingly, **IT IS ORDERED**, pursuant to Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act, that a waiver from the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act as to Investools and any current or future affiliates resulting from the entry of the Final Judgment is hereby granted.

By the Commission.

Elizabeth M. Murphy
Secretary

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

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT of 1933
Release No. 9091 / December 16, 2009

In the Matter of **Investools Inc.,** **Respondent.**	**ORDER UNDER RULE 502(e) OF THE SECURITIES ACT OF 1933 GRANTING A WAIVER OF THE RULE 602(b)(4) and 602(c)(2) DISQUALIFICATION PROVISIONS**

I.

Investools Inc. ("Investools") has submitted a letter, dated November 20, 2009, requesting a waiver of the Rule 602(b)(4) and 602(c)(2) disqualifications from the exemption from registration under Regulation E arising from Investools' settlement of an injunctive action commenced by the Commission.

II.

On December 10, 2009, the Commission filed a civil injunctive action in the United States District Court for the District of Columbia, alleging that Investools is liable as a controlling person under Section 20(a) of the Securities Exchange Act of 1934 ("Exchange Act") for violations by its employees of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5. In its complaint, the Commission alleged that certain Investools sales personnel committed fraud during sales presentations at workshops that Investools held throughout the United States. The complaint further alleged that, from 2004 to approximately June 2007, Investools failed to adequately supervise its sales personnel. The complaint alleged that, during that time, Investools management learned that certain of its speakers were claiming, at investor workshops, that their securities trading was tremendously profitable. The complaint also alleged that Investools never required its speakers to provide it with documentation substantiating their trading success claims, such as brokerage account statements or tax forms. On December 16, 2009, pursuant to Investools' consent, the United States District Court for the District of Columbia entered a Final Judgment permanently enjoining Investools from violating, directly or indirectly, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

III.

Under Rule 602(b)(4) of the Securities Act of 1933 ("Securities Act"), the Regulation E exemption is unavailable for the securities of small business investment company issuers or business development company issuers if such issuer or any of its affiliates is subject to a court order entered within the past five years "permanently restraining or enjoining such person from engaging in or continuing any conduct or practice in connection with the purchase or sale of securities." Rule 602(c)(2) of the Securities Act makes this exemption unavailable for the securities of any issuer if, among other things, any investment adviser or underwriter of the securities to be offered is "temporarily or permanently restrained or enjoined by any court from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer, or investment adviser." Rule 602(e) of the Securities Act provides, however, that the disqualification "shall not apply . . . if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied."

IV.

Based upon the representations set forth in Investools' request, the Commission has determined that pursuant to Rule 602(e) under the Securities Act a showing of good cause has been made that it is not necessary under the circumstances that the exemption be denied as a result of the Order.

Accordingly, **IT IS ORDERED**, pursuant to Rule 602(e) under the Securities Act, that a waiver from the application of the disqualification provisions of Rules 602(b)(4) and 602(c)(2) under the Securities Act resulting from the entry of the Order is hereby granted.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61181 / December 16, 2009

INVESTMENT ADVISERS ACT OF 1940
Release No. 2964 / December 16, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13717

In the Matter of

EQUITY SERVICES, INC.,

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 SECTION 15(b)(4) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Section 15(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act") against Equity Services, Inc. ("Respondent" or "ESI").

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 Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 and Section 15(b)(4) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

Summary

1. This matter involves ESI's failure to provide promised asset allocation monitoring services to certain of ESI's advisory clients. Beginning in early 2001, ESI marketed and sold an investment management program called ESI Illuminations Select through its nationwide network of investment advisory representatives. This program allowed investors to choose a model asset allocation portfolio of investments. From the program's inception through at least the summer of 2005, ESI represented to both current and prospective clients that it would periodically monitor each Illuminations Select account to determine whether its asset allocation remained consistent with the allocation associated with the chosen model portfolio and, if the allocation did not, take steps to ensure that the account was invested in the manner directed by the client. However, from the program's inception and continuing until the summer of 2005, ESI failed to monitor the asset allocation of Illuminations Select accounts.

Respondent

2. **Equity Services, Inc.**, headquartered in Montpelier, Vermont, is a registered investment adviser (SEC File No. 801-41722) and broker-dealer (SEC File No. 8-14286) operating through a nationwide network of offices. ESI conducts its investment advisory business under the name ESI Financial Advisers. As of August 27, 2009, ESI Financial Advisers had approximately $830 million in assets under management. ESI is a wholly-owned subsidiary of NLV Financial Corporation, which does business under the name National Life Group.

Facts

The ESI Illuminations Select Program

3. The ESI Illuminations Select Program is a wrap asset allocation/investment management program that utilizes open-end no-load and load-waived mutual funds as well as separately managed accounts. Investments in each client's account are spread among various mutual funds and/or general securities based upon one of seven asset allocation model portfolios. The models are comprised of a mix of equity, fixed income and money market offerings, and offer various levels of risk, with the most aggressive models being more heavily weighted toward equity offerings.

[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.

4. ESI introduced the Illuminations Select Program in early 2001 through its nationwide network of investment advisory representatives. Until the spring of 2002, the Illuminations Select Program permitted its clients to invest only in mutual funds. In approximately June 2002, ESI introduced a new Illuminations Select product called Discoverer Select, which permitted clients to invest part of their account assets in mutual funds and to have the rest of their account assets managed by one or more managers selected by the client from a list of managers recommended by ESI ("separately managed accounts"). When it introduced the Discoverer Select product, ESI renamed the original mutual fund-only Illuminations Select product as Flagship Select. In approximately April 2003, ESI introduced a third Illuminations Select product, Navigator Select, which permitted clients to invest only through separately managed accounts. From early 2001 through at least the summer of 2005, the minimum initial investment in a Flagship Select account, a Discoverer Select account, and a Navigator Select account was $50,000, $250,000, and $500,000, respectively. During that period, ESI generally charged Illuminations Select Program clients an advisory fee ranging from 1 to 2.5 percent of total assets.

ESI Failed to Monitor Accounts

5. From the program's inception through at least the summer of 2005, ESI represented to both current and prospective clients that it would periodically monitor each Illuminations Select account to determine whether its asset allocation remained consistent with the allocation associated with the chosen model portfolio and, if the allocation did not, take steps to ensure that the account was invested in the manner directed by the client. For example, one marketing piece stated: "Monitoring your portfolio and maintaining your asset allocation in the face of market changes are key considerations for the ESI Illuminations Select Program, thus ensuring your portfolio continues to be consistent with your investment objectives." Another promotional document stated: "Throughout your relationship, you will receive professional portfolio management according to your asset allocation plan. Your investments are continuously monitored and, as changes dictate, rebalanced to ensure they conform to your original asset mix." And a third marketing brochure stated: "When the Flagship Select program is utilized, the Investment Advisor Representative . . . and client choose the investments within the model. The portfolio choices and investment selections are monitored . . . Individual assets are reviewed daily, portfolios reviewed weekly, and re-balancing done automatically."

6. From the inception of the ESI Illuminations Select Program through the summer of 2005, ESI had monthly reports prepared that identified each account whose asset allocation varied by at least 10% from the chosen model portfolio. However, throughout this period, no one at ESI reviewed these variance reports or otherwise monitored the asset allocation of Illuminations Select accounts and ESI therefore failed to identify those accounts whose asset allocations were inconsistent with the chosen model portfolio.

7. In August 2003, members of the Commission's Office of Compliance Inspections

and Examinations ("OCIE") staff conducted a routine examination of ESI. In the course of this examination it was determined that, of the 563 ESI Illumination Select accounts then in existence, 232 (more than 41%) were allocated in a manner that was inconsistent with the chosen model portfolio. In a letter to Commission staff dated October 29, 2003, ESI stated that, from that point on, ESI would "monitor on a weekly basis activity in all [Illuminations Select] accounts to insure that the current portfolio allocation is substantially consistent with the model selected by the client . . . ." Consistent with this commitment, ESI amended its Form ADV on October 24, 2003 to state:

> "[ESI] will conduct oversight reviews of Illuminations Select accounts . . . [ESI] will review weekly exception reports intended to highlight any accounts where the investment allocation may be inconsistent with the client's investment objective and will take appropriate action to ensure that the actual investments are aligned with the client's investment objective. These reviews will be conducted by the Senior Vice President - Securities Operations, the Director - Advisory Services, or another [ESI] home office staff member acting under the supervision of either the above two managers."[2]

8. In late 2004, ESI's compliance department conducted a review of ESI's business and found that ESI was still not reviewing the monthly variance reports and that the asset allocation of more than 250 Illuminations Select accounts varied significantly from the allocation associated with the chosen model portfolio. The compliance department incorporated this finding into an April 2005 report to several ESI officials. In the wake of the compliance department's review, ESI determined to hire additional staff to perform the necessary monitoring of client accounts. Such staff did not begin working on the monitoring until September 2005.

9. In late August 2005, the OCIE staff conducted another examination of ESI that showed that ESI was still not periodically monitoring the asset allocations of Illuminations Select accounts. By late August 2005, the asset allocation of 679 of the 1,074 Flagship Select accounts that had been opened up to that time (more than 63%) had varied by at least 10% from the allocation associated with the chosen model portfolio for a period of at least 30 days.

[2] This language was inadvertently removed from ESI's Form ADV in December 2003 when ESI amended its Form ADV for an unrelated reason.

Violations

10. As a result of the conduct described above, ESI willfully[3] 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. Specifically, by misrepresenting that it would periodically monitor each ESI Illuminations Select account to determine whether its asset allocation remained consistent with the allocation associated with the chosen model portfolio and, if the allocation did not, take steps to ensure that the account was invested in the manner directed by the client, ESI engaged in conduct that operated as a fraud or deceit upon its clients.

Respondent's Remedial Acts

11. In determining to accept Respondent's Offer, the Commission considered the remedial acts undertaken by Respondent, including the hiring of additional staff and the compensating of Illuminations Flagship Select, Discoverer Select and Navigator Select clients harmed by Respondent's conduct in the amount of approximately $1.7 million.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in ESI's Offer of Settlement. It is hereby ORDERED that:

A. Pursuant to Section 203(e) of the Advisers Act and Section 15(b)(4) of the Exchange Act, ESI is hereby censured.

B. Pursuant to Section 203(k) of the Advisers Act, ESI shall cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act.

C. Pursuant to Section 203(i) of the Advisers Act and Section 21B of the Exchange Act, ESI shall, within ten business days of the entry of this Order, pay to the United States Treasury, a civil penalty in the amount of $300,000. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717 until the obligations are paid in full. Payment shall be: (A) made by United

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[3] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

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 ESI as the 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 Director, Division of Enforcement, Securities and Exchange Commission, 33 Arch Street, Suite 2300, Boston, MA 02110.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61174)

Order Granting Application for Extension of a Temporary Conditional Exemption Pursuant to Section 36(a) of the Exchange Act by the International Securities Exchange, LLC Relating to the Ownership Interest of International Securities Exchange Holdings, Inc. in an Electronic Communications Network

December 16, 2009

I. Introduction

On December 22, 2008, the Securities and Exchange Commission ("Commission") approved a proposal filed by the International Securities Exchange, LLC ("ISE" or "Exchange") in connection with corporate transactions (the "Transactions") in which, among other things, the parent company of ISE, International Securities Exchange Holdings, Inc. ("ISE Holdings"), purchased a 31.54% ownership interest in Direct Edge Holdings LLC ("Direct Edge"), the owner and operator of Direct Edge ECN ("DECN"), a registered broker-dealer and electronic communications network ("ECN").[1] Following the closing of the Transactions (the "Closing"), Direct Edge's wholly-owned subsidiary, Maple Merger Sub LLC ("Merger Sub") began to operate a marketplace for the trading of U.S. cash equity securities by Equity Electronic Access Members of ISE (the "Facility"), under ISE's rules and as a "facility," as defined in Section 3(a)(2) of the Securities Exchange Act of 1934 ("Exchange Act"),[2] of ISE.[3]

1 See Securities Exchange Act Release No. 59135 (December 22, 2008), 73 FR 79954 (December 30, 2008) (order approving File No. SR-ISE-2008-85).

2 15 U.S. C. 78c(a)(2).

3 Under Section 3(a)(2) of the Act, the term "facility," when used with respect to an exchange, includes "its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service."

DECN, which operates as an ECN and submits its limit orders to the Facility for display and execution, is an affiliate of ISE through ISE Holdings' equity interest in DE Holdings. DECN also is a facility, as defined in Section 3(a)(2) of the Exchange Act, of ISE because it is an affiliate of ISE used for the purpose of effecting and reporting securities transactions. Because DECN is a facility of ISE, ISE, absent exemptive relief, would be obligated under Section 19(b) of the Exchange Act to file with the Commission proposed rules governing the operation of DECN's systems and subscriber fees.

On December 22, 2008, the Commission exercised its authority under Section 36 of the Exchange Act to grant ISE a temporary exemption, subject to certain conditions, from the requirements under Section 19(b) of the Exchange Act with respect to DECN's proposed rules.[4] On June 19, 2009, the Commission extended this temporary exemption for an additional 180 days, subject to certain conditions.[5]

On November 16, 2009, ISE filed with the Commission, pursuant to Rule 0-12[6] under the Exchange Act, an application under Section 36(a)(1) of the Exchange Act[7] to extend the relief granted in the June Extension for an additional 180 days, subject to certain conditions.[8] This order grants ISE's request for a temporary extension of the relief provided in the June Extension, subject to the satisfaction of certain conditions, which are outlined below.

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4 See Securities Exchange Act Release No. 59133 (December 22, 2008), 73 FR 79940 (December 30, 2008) ("Exemption Order").

5 See Securities Exchange Act Release No. 60152 (June 19, 2009), 74 FR 30334 (June 25, 2009) ("June Extension").

6 17 CFR 240.0-12.

7 15 U.S.C. 78mm(a)(1).

8 See letter from Michael J. Simon, General Counsel and Secretary, ISE, to Elizabeth M. Murphy, Secretary, Commission, dated November 16, 2009 ("Extension Request").

II. Application for an Extension of the Temporary Conditional Exemption from the Section 19(b) Rule Filing Requirements

On November 16, 2009, ISE requested that the Commission exercise its authority under Section 36 of the Exchange Act to temporarily extend, subject to certain conditions, the temporary conditional exemption granted in the June Extension from the rule filing procedures of Section 19(b) of the Exchange Act in connection with ISE Holdings' equity ownership interest in DE Holdings and the continued operation of DECN as a facility of ISE.[9]

The Extension Request notes that on May 7, 2009, EDGA Exchange, Inc., and EDGX Exchange, Inc. (together, the "Exchange Subsidiaries"), two wholly-owned subsidiaries of DE Holdings, filed with the Commission Form 1 applications (the "Form 1 Applications") to register as national securities exchanges under Section 6 of the Exchange Act.[10] According to the Extension Request, DECN intends to file a "Cessation of Operations Report" with the Commission and to cease operations as an ECN shortly following any Commission approval of the Form 1 Applications and the Exchange Subsidiaries commencing operations as national securities exchanges.[11]

Because DECN will cease operations as an ECN if the Commission approves the Form 1 Applications, ISE expects that DECN will continue to operate as a facility of ISE for a relatively brief period.[12] In addition, ISE believes that it would be unduly burdensome and inefficient to require DECN's operating rules to be separately subject to the Section 19(b) rule filing process because the published rules of the Exchange Subsidiaries "substantially align with DECN's

9 See Extension Request at 1.

10 Id. at 2. The Form 1 Applications have been published for notice and comment. See Securities Exchange Act Release No. 60651 (September 11, 2009), 74 FR 47827 (September 17, 2009) ("Form 1 Applications Notice").

11 See Extension Request at 2.

12 Id.

operations in practice and DECN is only operating temporarily as a facility of ISE while the Commission considers the Form 1 Applications."[13]

ISE has asked the Commission to exercise its authority under Section 36 of the Exchange Act to grant ISE a 180-day extension of the June Extension's relief, subject to certain conditions, from the Section 19(b) rule filing requirements that otherwise would apply to DECN as a facility of ISE.[14] The extended temporary conditional exemption would commence immediately and would permit the continued operation of DECN while the Commission considers the Form 1 Applications that, if approved, would allow the Exchange Subsidiaries to operate in place of DECN.[15] ISE believes that the extended temporary conditional exemption will help to ensure an orderly transition from DECN to the proposed Exchange Subsidiaries.[16]

ISE states, in addition, that the extended exemption will not diminish the Commission's ability to monitor ISE and DECN.[17] In this regard, ISE notes that to the extent that ISE makes changes to its systems, including the Facility, during the extended temporary exemption period, or thereafter, it remains subject to Section 19(b) and thus obligated to file proposed rule changes with the Commission.[18] Further, in the Extension Request, ISE commits to satisfying certain conditions, as outlined below, which are identical to the conditions in the Exemption Order and

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13 Id.

14 Id.

15 According to ISE, it would be impracticable for DECN to display its limit orders other than on the Facility. See Extension Request at 2-3.

16 See Extension Request at 3.

17 Id.

18 Id.

the June Extension.[19] For example, as a condition to the extended temporary exemption, ISE will be required to submit proposed rule changes with respect to any material changes to DECN's functions during the exemption period.[20] ISE notes, however, that neither ISE nor DECN anticipates any material changes to DECN's functionality during the extended temporary exemption period.[21]

III. Order Granting Extension of Temporary Conditional Section 36 Exemption

In 1996, Congress gave the Commission greater flexibility to regulate trading systems, such as DECN, by granting the Commission broad authority to exempt any person from any of the provisions of the Exchange Act and to impose appropriate conditions on their operation.[22] Specifically, NSMIA added Section 36(a)(1) to the Exchange Act, which provides that "the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of [the Exchange Act] or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."[23] In enacting Section 36, Congress indicated that it expected that "the Commission will use this authority to promote efficiency, competition and

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19 ISE also represents that it has complied with the conditions in the Exemption Order and the June Extension and that it will continue to comply with these conditions during any extension of the relief granted. See Extension Request at 3.

20 See Extension Request at note 6.

21 See Extension Request at note 5.

22 15 U.S.C. 78mm(a). Section 36 of the Exchange Act was enacted as part of the National Securities Markets Improvements Act 1996, Pub. L. No. 104-290 ("NSMIA").

23 15 U.S.C. 78mm(a)(1).

capital formation."[24] It particularly intended to give the Commission sufficient flexibility to respond to changing market and competitive conditions:

> The Committee recognizes that the rapidly changing marketplace dictates that effective regulation requires a certain amount of flexibility. Accordingly, the bill grants the SEC general exemptive authority under both the Securities Act and the Securities Exchange Act. This exemptive authority will allow the Commission the flexibility to explore and adopt new approaches to registration and disclosure. It will also enable the Commission to address issues relating to the securities markets more generally. For example, the SEC could deal with the regulatory concerns raised by the recent proliferation of electronic trading systems, which do not fit neatly into the existing regulatory framework.[25]

As noted above, in December 2008 the Commission exercised its Section 36 exemptive authority to grant ISE a temporary exemption, subject to certain conditions, from the 19(b) rule filing requirements in connection with the Transaction.[26] On June 19, 2009, the Commission extended ISE's temporary exemption for an additional 180 days.[27] In addition, the Commission previously granted similar exemptive relief in connection with Nasdaq's acquisition of Brut, LLC, the operator of the Brut ECN.[28]

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24 H.R. Rep. No. 104-622, 104th Cong., 2d Sess. 38 (1996).

25 S. Rep. No. 104-293, 104th Cong., 2d Sess. 15 (1996).

26 See Exemption Order, supra note 4.

27 See June Extension, supra note 5.

28 See Securities Exchange Act Release No. 50311 (September 3, 2004), 69 FR 54818 (September 10, 2004). Although granting the ISE's Extension Request would result in a temporary exemption longer than the exemption granted in connection with Nasdaq's acquisition of Brut, LLC, the Commission believes that an extended exemption is warranted, in this case, to provide adequate time to address the regulatory issues raised by ISE's ownership structure. In this regard, the Commission notes that, as a result of ISE's equity ownership interest in Direct Edge, the non-U.S. owners of ISE will have an indirect ownership interest in Direct Edge and in the Exchange Subsidiaries, as well as in ISE. When the Commission approved the 2007 transaction in which ISE Holdings became a wholly-owned indirect subsidiary of Eurex Frankfurt AG, the corporate governing documents of ISE Holdings and its parent company, U.S. Exchange Holdings, and corporate resolutions adopted by the non-U.S. owners, included provisions (the "Regulatory Provisions") designed to maintain the independence of the regulatory function of ISE, the sole national securities exchange then owned by ISE Holdings. See

Section 19(b)(1) of the Exchange Act requires a self-regulatory organization ("self-regulatory organization" or "SRO"), including ISE, to file with the Commission its proposed rule changes accompanied by a concise general statement of the basis and purpose of the proposed rule change. Once a proposed rule change has been filed with the Commission, the Commission is required to publish notice of it and provide an opportunity for public comment. The proposed rule change may not take effect unless approved by the Commission by order, unless the rule change is within the class of rule changes that are effective upon filing pursuant to Section 19(b)(3)(A) of the Act.[29]

Section 19(b)(1) of the Exchange Act defines the term "proposed rule change" to mean "any proposed rule or rule change in, addition to, or deletion from the rules of [a] self-regulatory organization." Pursuant to Section 3(a)(27) and 3(a)(28) of the Exchange Act, the term "rules of a self-regulatory organization" means (1) the constitution, articles of incorporation, bylaws and

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Securities Exchange Act Release No. 56955 (December 13, 2007), 72 FR 71979 (December 19, 2007) (File No. SR-ISE-2007-101). In connection with ISE Holdings' subsequent purchase of an ownership interest in Direct Edge, ISE has filed proposed changes to the governing documents of ISE Holdings and U.S. Exchange Holdings that apply the Regulatory Provisions to any national securities exchange, or facility there of, controlled, directly or indirectly, by ISE Holdings. See, e.g., Securities Exchange Act Release Nos. 59135 (December 22, 2008), 73 FR 79954 (December 30, 2008) (File No. SR-ISE-2008-85) (approving changes to the Certificate of Incorporation and Bylaws of ISE Holdings); and 61005 (November 16, 2009) (notice of filing of File No. SR-ISE-2009-90) (proposing changes to Trust Agreement and to the Certificate of Incorporation and Bylaws of U.S. Exchange Holdings). Similarly, the Form 1 Applications included forms of supplemental corporate resolutions, to be adopted by the non-U.S. owners prior to any Commission approval of the Form 1 Applications. These supplemental corporate resolutions will apply the Regulatory Provisions to the Exchange Subsidiaries. Accordingly, the amended corporate governing documents of ISE Holdings and U.S. Exchange Holdings, and the supplemental corporate resolutions of the non-U.S. owners, will apply to the Exchange Subsidiaries following any Commission approval of the Form 1 Applications. In light of the time required to amend the corporate governing documents of ISE Holdings and U.S. Exchange Holdings, and to supplement the corporate resolutions of the non-U.S. owners, the Commission believes that it is appropriate to grant the ISE's Extension Request.

29 15 U.S.C. 78s(b)(3)(A).

rules, or instruments corresponding to the foregoing, of an SRO, and (2) such stated policies, practices and interpretations of an SRO (other than the Municipal Securities Rulemaking Board) as the Commission, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules. Rule 19b-4(b) under the Exchange Act,[30] defines the term "stated policy, practice, or interpretation" to mean generally "any material aspect of the operation of the facilities of the self-regulatory organization or any statement made available to the membership, participants, or specified persons thereof that establishes or changes any standard, limit, or guideline with respect to rights and obligations of specified persons or the meaning, administration, or enforcement of an existing rule."

The term "facility" is defined in Section 3(a)(2) of the Exchange Act, with respect to an exchange, to include "its premises, tangible or intangible property whether on the premises or not, any right to use such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service."

In its Extension Request, ISE acknowledges that since the Closing, Merger Sub has operated the Facility as a facility of ISE.[31] Absent an exemption, Section 19(b) of the Exchange Act and Rule 19b-4 thereunder would require ISE to file proposed rules with the Commission to allow ISE to operate DECN as a facility of ISE.

30 17 CFR 240.19b-4(b).

31 See Extension Request at 1. As discussed above, ISE owns a 31.54% ownership interest in DE Holdings, the sole owner of Merger Sub.

In its Extension Request, ISE notes that the Exchange Subsidiaries have filed Form 1 Applications, which have been published for comment,[32] and that DECN intends to cease operations as an ECN shortly after any Commission approval of the Form 1 Applications and the Exchange Subsidiaries' commencement of operations as national securities exchanges.[33] Accordingly, ISE expects that DECN will continue to operate as a facility of ISE for a relatively brief period of time.[34] ISE represents that it has complied with the conditions in the Exemption Order and the June Extension and that it will continue to comply with these conditions during an extension of the relief granted in the June Extension.[35]

The Commission believes that it is appropriate to grant a temporary extension of the relief provided in the June Extension, subject to the conditions described below, to allow DECN to continue to operate as a facility of ISE without being subject to the rule filing requirements of Section 19(b) of the Exchange Act for a temporary period.[36] Accordingly, the Commission has determined to grant ISE's request for an extension of the relief provided in the June Extension, subject to certain conditions, for a period not to exceed 180 days. The Commission finds that the temporary extended conditional exemption from the provisions of Section 19(b) of the Exchange Act is appropriate in the public interest and is consistent with the protection of investors. In particular, the Commission believes that the temporary extended exemption should help promote

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32 See Form 1 Applications Notice, supra note 10.

33 See Extension Request at 2. The Commission must approve an application for registration as a national securities exchange, or institute proceedings to determine whether the application should be denied, within 90 days of publication of notice of filing of the application, or within such longer period as to which the applicant consents. See Exchange Act Section 19(a)(1), 15 U.S.C. 78s(a)(1).

34 Id. at 2.

35 Id. at 3.

36 In granting this relief, the Commission makes no finding regarding whether ISE's operation of DECN as a facility would be consistent with the Exchange Act.

efficiency and competition in the market by allowing DECN to continue to operate as an ECN for a limited period of time while the Commission considers the Form 1 Applications. In this regard, the Commission notes ISE's belief that it would be unduly burdensome and inefficient to require DECN's operating rules to be separately subjected to the Section 19(b) rule filing and approval process because DECN will operate only temporarily as a facility of ISE while the Commission considers the Form 1 Applications. In addition, the Commission notes that the Form 1 Applications, which include the rules of the Exchange Subsidiaries, were published for comment on September 17, 2009.[37] According to ISE, the rules of the Exchange Subsidiaries "substantially align" with DECN's operations in practice.[38] Accordingly, the publication of the Form 1 Applications should help to mitigate any concerns regarding transparency with respect to the rules under which DECN operates temporarily as a facility of ISE.

To provide the Commission with the opportunity to review and act upon any proposal to change DECN's fees or to make material changes to DECN's operations as an ECN during the period covered by the extended temporary exemption, as well as to ensure that the Commission's ability to monitor ISE and DECN is not diminished by the extended temporary exemption, the Commission is imposing the following conditions while the extended temporary exemption is in effect.[39] The Commission believes such conditions are necessary and appropriate in the public interest for the protection of investors. Therefore, the Commission is granting to ISE an extended temporary exemption, pursuant to Section 36 of the Exchange Act, from the rule filing

37 See Securities Exchange Act Release No. 60651 (September 11, 2009), 74 FR 47827 (September 17, 2009).

38 See Exemption Request at 2.

39 See Extension Request at note 6.

requirements imposed by Section 19(b) of the Exchange Act as set forth above, provided that ISE and DECN comply with the following conditions:

(1) DECN remains a registered broker-dealer under Section 15 of the Exchange Act[40] and continues to operate as an ECN;

(2) DECN operates in compliance with the obligations set forth under Regulation ATS;

(3) DECN and ISE continue to operate as separate legal entities;

(4) ISE files a proposed rule change under Section 19 of the Exchange Act[41] if any material changes are sought to be made to DECN's operations. A material change would include any changes to a stated policy, practice, or interpretation regarding the operation of DECN or any other event or action relating to DECN that would require the filing of a proposed rule change by an SRO or an SRO facility;[42]

(5) ISE files a proposed rule change under Section 19 of the Exchange Act if DECN's fee schedule is sought to be modified; and

(6) ISE treats DECN the same as other ECNs that participate in the Facility, and, in particular, ISE does not accord DECN preferential treatment in how DECN submits orders to the Facility or in the way its orders are displayed or executed.[43]

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40 15 U.S.C. 78o.

41 15 U.S.C. 78s.

42 See Section 19(b) of the Exchange Act and Rule 19b-4 thereunder. The Commission notes that a material change would include, among other things, changes to DECN's operating platform; the types of securities traded on DECN; DECN's types of subscribers; or the reporting venue for trading that takes place on DECN. The Commission also notes that any rule filings must set forth the operation of the DECN facility sufficiently so that the Commission and the public are able to evaluate the proposed changes.

43 See Extension Request at note 6.

In addition, the Commission notes that the Financial Industry Regulatory Authority is currently the Designated Examining Authority for DECN.

For the reasons discussed above, the Commission finds that the extended temporary conditional exemptive relief requested by ISE is appropriate in the public interest and is consistent with the protection of investors.

IT IS ORDERED, pursuant to Section 36 of the Exchange Act,[44] that the application for an extended temporary conditional exemption is granted for a period of 180 days, effective immediately.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Deputy Secretary

44 15 U.S.C. 78mm.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61180 / December 16, 2009

INVESTMENT ADVISERS ACT OF 1940
Release No. 2963 / December 16, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13716

In the Matter of **STEPHEN A. ENGLESE,** **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(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTION 15(b)(6) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Section 15(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act") against Stephen A. Englese ("Respondent" or "Englese").

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 Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 and Section 15(b)(6) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

Summary

1. This matter involves the failure by Stephen A. Englese and Equities Services, Inc. ("ESI") to provide promised asset allocation monitoring services to certain of ESI's advisory clients. Beginning in early 2001, ESI marketed and sold an investment management program called ESI Illuminations Select through its nationwide network of investment advisory representatives. This program allowed investors to choose a model asset allocation portfolio of investments. From the program's inception through at least the summer of 2005, ESI represented to both current and prospective clients that it would periodically monitor each Illuminations Select account to determine whether its asset allocation remained consistent with the allocation associated with the chosen model portfolio and, if the allocation did not, take steps to ensure that the account was invested in the manner directed by the client. However, from the program's inception and continuing until the summer of 2005, ESI failed to monitor the asset allocation of Illuminations Select accounts. Throughout the period at issue, Englese was ESI's Senior Vice President for Securities Operations. From at least October 2003, when a Commission examination showed that ESI was not monitoring the asset allocation of these accounts, through the summer of 2005, Englese was responsible for ensuring that the monitoring was being done.

Respondent

2. **Stephen A. Englese**, 56, a resident of Rutland, Vermont, is ESI's Senior Vice President for Financial Products and Advisory Services. He is an associated person of a registered investment adviser and a registered representative of a broker-dealer (CRD No. 1011107). Englese has worked for ESI since 1985, and reported to ESI's president from early 2001 through August 2005. Englese has Series 7, 24, 63 and 65 licenses and he is a member of the Colorado bar.

Related Party

3. **Equity Services, Inc.**, headquartered in Montpelier, Vermont, is a registered investment adviser (SEC File No. 801-41722) and broker-dealer (SEC File No. 8-14286) operating through a nationwide network of offices. ESI conducts its investment advisory business under the name ESI Financial Advisers. As of March 1, 2009, ESI Financial Advisers had approximately $1 billion in assets under management. ESI is a wholly-owned subsidiary of NLV Financial Corporation, which does business under the name National Life Group.

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

Facts

The ESI Illuminations Select Program

4. The ESI Illuminations Select Program is a wrap asset allocation/investment management program that utilizes open-end no-load and load-waived mutual funds as well as separately managed accounts. Investments in each client's account are spread among various mutual funds and/or general securities based upon one of seven asset allocation model portfolios. The models are comprised of a mix of equity, bond and money market offerings, and offer various levels of risk, with the most aggressive models being more heavily weighted toward equity offerings.

5. ESI introduced the Illuminations Select Program in early 2001 through its nationwide network of investment advisory representatives. Until the spring of 2002, the Illuminations Select Program permitted its clients to invest only in mutual funds. In approximately June 2002, ESI introduced a new Illuminations Select product called Discoverer Select, which permitted clients to invest part of their account assets in mutual funds and to have the rest of their account assets managed by one or more managers selected by the client from a list of managers recommended by ESI ("separately managed accounts"). When it introduced the Discoverer Select product, ESI renamed the original mutual fund-only Illuminations Select product as Flagship Select. In approximately April 2003, ESI introduced a third Illuminations Select product, Navigator Select, which permitted clients to invest only through separately managed accounts. From early 2001 through at least the summer of 2005, the minimum initial investment in a Flagship Select account, a Discoverer Select account, and a Navigator Select account was $50,000, $250,000, and $500,000, respectively. During that period, ESI generally charged Illuminations Select Program clients an advisory fee ranging from 1 to 2.5 percent of total assets.

ESI Failed to Monitor Accounts as Promised

6. From the program's inception through at least the summer of 2005, ESI represented to both current and prospective clients that it would periodically monitor each Illuminations Select account to determine whether its asset allocation remained consistent with the allocation associated with the chosen model portfolio and, if the allocation did not, take steps to ensure that the account was invested in the manner directed by the client. For example, one marketing piece stated: "Monitoring your portfolio and maintaining your asset allocation in the face of market changes are key considerations for the ESI Illuminations Select Program, thus ensuring your portfolio continues to be consistent with your investment objectives." Another promotional document stated: "Throughout your relationship, you will receive professional portfolio management according to your asset allocation plan. Your investments are continuously monitored and, as changes dictate, rebalanced to ensure they conform to your

original asset mix." And a third marketing brochure stated: "When the Flagship Select program is utilized, the Investment Advisor Representative . . . and client choose the investments within the model. The portfolio choices and investment selections are monitored . . . Individual assets are reviewed daily, portfolios reviewed weekly, and re-balancing done automatically."

7. From the inception of the ESI Illuminations Select Program through the summer of 2005, ESI had monthly reports prepared that identified each account whose asset allocation varied by at least 10% from the chosen model portfolio. However, throughout this period, no one at ESI reviewed these variance reports or otherwise monitored the asset allocation of Illuminations Select accounts and ESI therefore failed to identify those accounts whose asset allocations were inconsistent with the chosen model portfolio.

8. In August 2003, members of the Commission's Office of Compliance Inspections and Examinations ("OCIE") staff conducted a routine examination of ESI. In the course of this examination it was determined that, of the 563 ESI Illumination Select accounts then in existence, 232 (more than 41%) were allocated in a manner that was inconsistent with the chosen model portfolio. In a letter to Commission staff dated October 29, 2003, ESI stated that, from that point on, ESI would "monitor on a weekly basis activity in all [Illuminations Select] accounts to insure that the current portfolio allocation is substantially consistent with the model selected by the client . . . ." Consistent with this commitment, ESI amended its Form ADV on October 24, 2003 to state:

> "[ESI] will conduct oversight reviews of Illuminations Select accounts . . . [ESI] will review weekly exception reports intended to highlight any accounts where the investment allocation may be inconsistent with the client's investment objective and will take appropriate action to ensure that the actual investments are aligned with the client's investment objective. These reviews will be conducted by the Senior Vice President - Securities Operations, the Director - Advisory Services, or another [ESI] home office staff member acting under the supervision of either the above two managers."[2]

[2] This language was inadvertently removed from ESI's Form ADV in December 2003 when ESI amended its Form ADV for an unrelated reason.

Englese Failed to Ensure that Client Accounts Were Monitored

9. From October 2003 through the summer of 2005, Englese was ESI's Senior Vice President for Securities Operations. Throughout this period, Englese was the direct supervisor of ESI's Director of Advisory Services. Englese reviewed and approved the statement set forth above before it was incorporated into ESI's Form ADV. Consequently, during the period in question, Englese knew that either he or another ESI employee whom he supervised would be responsible for performing the asset allocation monitoring.

10. Prior to approving the October 24, 2003 amendment to the Form ADV, Englese determined that it would take a person's full-time effort to perform the asset allocation monitoring. Englese further determined that neither he, the Director of Advisory Services, nor anyone currently under their supervision had the time to perform the monitoring. Englese therefore concluded that an additional full-time staff person would be needed to fulfill this function.

11. In late 2004, ESI's compliance department conducted a review of ESI's business and found that ESI was still not reviewing the monthly variance reports and that the asset allocation of more than 250 Illuminations Select accounts varied significantly from the allocation associated with the chosen model portfolio. The compliance department incorporated this finding into an April 2005 report to several ESI officials. In the wake of the compliance department's review, ESI determined to hire additional staff to perform the necessary monitoring of client accounts. Such staff did not begin working on the monitoring until September 2005.

12. In late August 2005, the OCIE staff conducted another examination of ESI that showed that ESI was still not periodically monitoring the asset allocations of Illuminations Select accounts. By late August 2005, the asset allocation of 679 of the 1,074 Flagship Select accounts that had been opened up to that time (more than 63%) had varied by at least 10% from the allocation associated with the chosen model portfolio for a period of at least 30 days.

13. From at least the fall of 2003 through the summer of 2005, Englese knew that ESI was not periodically monitoring the asset allocation of Illuminations Select accounts. He did not take the necessary steps to ensure that such monitoring was done notwithstanding the fact that he understood that he was responsible for such monitoring. Nor did he ever recommend that ESI remove the asset allocation monitoring representations from its Illuminations Select marketing materials, notify the Illuminations Select Program clients that the promised asset allocation monitoring was not being performed, close the Illuminations Select Program to new clients, or close the Illuminations Select Program altogether.

Violations

14. As a result of the conduct described above, Englese willfully aided and abetted and caused ESI's violations of Section 206(2) of the Advisers Act, which makes it 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.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Englese's Offer of Settlement. It is hereby ORDERED that:

A. Pursuant to Section 203(f) of the Advisers Act and Section 15(b)(6) of the Exchange Act, Englese is hereby censured.

B. Pursuant to Section 203(k) of the Advisers Act, Englese shall cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act.

C. Pursuant to Section 203(i) of the Advisers Act and Section 21B of the Exchange Act, Englese shall pay a civil penalty in the amount of $25,000 to the United States Treasury according to the following schedule: one installment of $12,500 within ten days after the entry of the Order and a second installment of $12,500 within 180 days thereafter. If any payment described above is not made by the date the payment is required by this Order, the entire outstanding balance plus any additional interest accrued pursuant to 31 U.S.C. § 3717 shall be due and payable immediately, without further application. Payments shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Stephen A. Englese 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 Director, Division of Enforcement, Securities and Exchange Commission, 33 Arch Street, Suite 2300, Boston, MA 02110.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

[Release No. IC-29093; File No. 812-13728]

Investools Inc., et al.; Notice of Application and Temporary Order

December 16, 2009

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

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

Summary of Application: Applicants have received a temporary order exempting them from section 9(a) of the Act, with respect to an injunction entered against Investools Inc. ("Investools") on December 16, 2009 by the United States District Court for the District of Columbia (the "Injunction"), until the Commission takes final action on an application for a permanent order. Applicants also have applied for a permanent order.

Applicants: Investools, Amerivest Investment Management, LLC ("Amerivest"), and TDAM USA Inc. ("TDAM USA") (collectively, other than Investools, the "Fund Servicing Applicants," and together with Investools, the "Applicants").[1]

Filing Date: The application was filed on December 11, 2009, and amended on December 11, 2009 and December 16, 2009.

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 January 11,

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[1] Applicants request that any relief granted pursuant to the application also apply to any other company of which Investools is or hereafter may become an affiliated person within the meaning of section 2(a)(3) of the Act (together with the Applicants, the "Covered Persons").

2010, and should be accompanied by proof of service on Applicants, in the form of an affidavit, or for lawyers, a certificate of service. Hearing requests should state the nature of the writer's interest, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission's Secretary.

Addresses: Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090; Applicants: Investools, 13947 S. Minuteman Dr., Draper, UT 84020; Amerivest, 1005 North Ameritrade Place, Bellevue, NE 68005; and TDAM USA, 161 Bay Street, 35th Floor, TD Canada Trust Tower, Toronto, Ontario, Canada M5J 2T2.

For Further Information Contact: Steven I. Amchan, Senior Counsel, at (202) 551-6826, or Jennifer L. Sawin, Branch Chief, at (202) 551-6821, (Division of Investment Management, Office of Investment Company Regulation).

Supplementary Information: The following is a temporary order and a summary of the application. The complete application may be obtained via the Commission's Web site by searching for the file number, or an applicant using the Company name box, at http://www.sec.gov/search/search.htm or by calling (202) 551-8090.

Applicants' Representations:

1. Investools and Amerivest are indirect, wholly-owned subsidiaries of TD AMERITRADE Holding Corporation ("TD Ameritrade Holding"). The Toronto-Dominion Bank ("TD Bank") owns approximately 45% of the outstanding common stock of TD Ameritrade Holding. TDAM USA is a direct, wholly-owned subsidiary of TD Bank. Investools was acquired by TD Ameritrade Holding in June 2009 as part of TD Ameritrade Holding's acquisition of thinkorswim Group, Inc. Investools does not provide, and no existing company of which Investools is an affiliated person (other than the Fund Servicing

Applicants) currently provides, Fund Service Activities to any registered investment company.[2]

2. The Fund Servicing Applicants are registered as investment advisers under the Investment Advisers Act of 1940 and provide investment advisory or sub-advisory services to Funds.

3. On December 16, 2009, the United States District Court for the District of Columbia entered a judgment against Investools ("Judgment") in a matter brought by the Commission.[3] The Commission alleged in the complaint ("Complaint") that Defendants Michael J. Drew ("Drew") and Eben D. Miller ("Miller"), employees of Investools, committed fraud during sales presentations at workshops held by Investools. The Complaint also alleged that while Investools had compliance policies requiring speakers to have proof of the validity of success claims, it did not require Drew, Miller, or other speakers to provide it with substantiating documentation after learning they were claiming that their securities trading was tremendously profitable. The Complaint alleges that Investools is liable as a controlling person under section 20(a) of the Securities Exchange Act of 1934 ("Exchange Act") for violations by its speakers of section 10(b) of the Exchange Act and rule 10b-5 thereunder. Without admitting or denying the allegations in the Complaint, except as to jurisdiction, Investools consented to the entry of the Judgment that included, among other things, the entry of the Injunction.

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2 "Fund Service Activities" refers to serving or acting in the capacity of employee, officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company, or principal underwriter for any registered open-end company, registered unit investment trust, or registered face-amount certificate company. Any registered investment company to which a Covered Person provides Fund Service Activities is a "Fund."

Applicants' Legal Analysis:

1. Section 9(a)(2) of the Act, in relevant part, prohibits a person who has been enjoined from, among other things, engaging in or continuing any conduct or practice in connection with the purchase or sale of a security from acting, among other things, as an investment adviser or depositor of any registered investment company or a principal underwriter for any registered open-end investment company, registered unit investment trust or registered face-amount certificate company. Section 9(a)(3) of the Act makes the prohibition in section 9(a)(2) applicable to a company, any "affiliated person" of which has been disqualified under the provisions of section 9(a)(2). Section 2(a)(3) of the Act defines "affiliated person" to include, among others, any person directly or indirectly controlling, controlled by, or under common control with, the other person. Applicants state that Investools is an affiliated person of each of the Fund Servicing Applicants within the meaning of section 2(a)(3) of the Act. Applicants state that the entry of the Injunction results in Applicants being subject to the disqualification provisions of section 9(a) of the Act.

2. Section 9(c) of the Act provides that the Commission shall grant an application for exemption from the disqualification provisions of section 9(a) of the Act if it is established that these provisions, as applied to the Applicants, are unduly or disproportionately severe or that the Applicants' conduct has been such as not to make it against the public interest or the protection of investors to grant the exemption. Applicants have filed an application pursuant to section 9(c) seeking a temporary and permanent order exempting them and Covered Persons from the disqualification provisions of section 9(a) of the Act.

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[3] Securities and Exchange Commission v. Investools Inc., Michael J. Drew and Eben D. Miller, Final Judgment as to Defendant Investools Inc., 09 Civ. 02343 (D.D.C. December 16, 2009).

3. Applicants believe they meet the standards for exemption specified in section 9(c). Applicants state that the prohibitions of section 9(a) as applied to them would be unduly and disproportionately severe and that the conduct of the Applicants has been such as not to make it against the public interest or the protection of investors to grant the exemption from section 9(a).

4. Applicants state that the alleged conduct giving rise to the Injunction did not involve any of the Applicants providing Fund Service Activities to any registered investment company and that the alleged conduct occurred prior to TD Ameritrade Holding's acquisition of thinkorswim Group, Inc. when the Fund Servicing Applicants were not affiliated persons of Investools. Applicants also state that none of the current or former directors, officers, or employees of the Fund Servicing Applicants had any knowledge of, or participation in, the violative conduct alleged in the Complaint. Applicants further state that the personnel at Investools who were involved in the violations alleged in the Complaint have had no, and will not have any future, involvement in providing Fund Service Activities to Funds.

5. Applicants state that the inability of the Fund Servicing Applicants to continue to serve as investment adviser or sub-adviser to the Funds would result in potential hardship for the Funds and their shareholders. Applicants will distribute to the boards of directors of the Funds ("Boards"), as soon as reasonably practicable and to the extent not already completed, written materials regarding the Judgment, any impact on the Funds, and the application. These materials will include an offer to meet in person to discuss the materials with each Board, including the directors who are not "interested persons," as defined in section 2(a)(19) of the Act, of the Fund, and their independent legal counsel as defined in rule 0-1(a)(6) under the Act, if any. Applicants state they will provide each Board with all

information concerning the Judgment and the application that is necessary for the Funds to fulfill their disclosure and other obligations under the federal securities laws.

6. Applicants also state that, if the Fund Servicing Applicants were barred from providing investment advisory services to the Funds, the effect on their businesses and employees would be severe. Applicants state that the Fund Servicing Applicants have committed substantial capital and other resources to establish an expertise in advising and sub-advising Funds. Applicants further state that prohibiting the Applicants from engaging in Fund Service Activities would not only adversely affect their businesses, but would also adversely affect approximately 52 employees who are actively involved in those activities.

7. Applicants previously have received exemptions under section 9(c) as the result of conduct that triggered section 9(a) as described in greater detail in the application.

Applicants' Condition:

Applicants agree that any order granting the requested relief will be subject to the following condition:

> Any temporary exemption granted pursuant to the application shall be without prejudice to, and shall not limit the Commission's rights in any manner with respect to, any Commission investigation of, or administrative proceedings involving or against, Covered Persons, including, without limitation, the consideration by the Commission of a permanent exemption from section 9(a) of the Act requested pursuant to the application or the revocation or removal of any temporary exemptions granted under the Act in connection with the application.

Temporary Order:

The Commission has considered the matter and finds that Applicants have made the necessary showing to justify granting a temporary exemption.

Accordingly,

IT IS HEREBY ORDERED, pursuant to section 9(c) of the Act, that Applicants and any other Covered Persons are granted a temporary exemption from the provisions of section 9(a), solely with respect to the Injunction, subject to the condition in the application, from December 16, 2009, until the Commission takes final action on their application for a permanent order.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Deputy Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61188 / December 17, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13718

In the Matter of **American Sports Development Group, Inc., Antex Biologics, Inc. (n/k/a ABI Liquidating Corp.), Cybernet Internet Services International, Inc., Cyper Media, Inc., Frisby Technologies, Inc., Graphco Holdings Corp., Investors Insurance Group, Inc., ITC Learning Corp., and Speizman Industries, Inc.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents American Sports Development Group, Inc., Antex Biologics, Inc. (n/k/a ABI Liquidating Corp.), Cybernet Internet Services International, Inc., Cyper Media, Inc., Frisby Technologies, Inc., Graphco Holdings Corp., Investors Insurance Group, Inc., ITC Learning Corp., and Speizman Industries, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. American Sports Development Group, Inc. ("ASDP")[1] (CIK No. 1073874) is a void Delaware corporation located in Greenville, South Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ASDP is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended December 31, 2003, which reported a net loss of $4,523,106 for the prior year. As of December 15, 2009, the common stock of ASDP was quoted on the Pink Sheets operated by Pink OTC Markets, Inc. ("Pink Sheets"), had six market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

2. Antex Biologics, Inc. (n/k/a ABI Liquidating Corp.) ("ANXB") (CIK No. 893692) is a dissolved Delaware corporation located in Gaithersburg, Maryland with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ANXB 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, 2002, which reported a net loss of $7,569,303 for the prior nine months. On March 27, 2003, ANXB filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Maryland which was terminated on February 10, 2005. On June 2, 2003, ANXB changed its name in the records of the Delaware Secretary of State to ABI Liquidating Corp., but failed to report that change to the Commission on Form 8-K or update its records in the Commission's EDGAR database as required by Commission rules. As of December 15, 2009, the common stock of ANXB was traded on the over-the-counter markets.

3. Cybernet Internet Services International, Inc. ("ZNET") (CIK No. 1070658) is a void Delaware corporation located in Vancouver, British Columbia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ZNET 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, 2003, which reported a net loss of $18,745,000 for the prior nine months. On December 24, 2003, the company filed a Form 8-K stating that it has ceased operations as of December 22, 2003. As of December 15, 2009, the common stock of ZNET was quoted on the Pink Sheets, had eight market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

4. Cyper Media, Inc. ("CYPM") (CIK No. 1163967) is a New York corporation located in Toronto, Ontario with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CYPM 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, 2004, which reported a net loss of $199,111 for the prior three months. As of December 15, 2009, the common stock of CYPM 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).

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[1] The short form of each issuer's name is also its stock symbol.

5. Frisby Technologies, Inc. ("FRIZQ") (CIK No. 1051904) is a void Delaware corporation located in Advance, North Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). FRIZQ 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, 2002, which reported a net loss of $3,995,408 for the prior nine months. On January 16, 2003, FRIZQ filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Middle District of North Carolina which was terminated on June 12, 2008. As of December 15, 2009, the common stock of FRIZQ was quoted on the Pink Sheets, had three market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

6. Graphco Holdings Corp. ("GHCP") (CIK No. 1168251) is a void Delaware corporation located in New Hope, Pennsylvania with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GHCP 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, 2003, which reported a net loss of $3,340,223 for the prior nine months. As of December 15, 2009, the common stock of GHCP was quoted on the Pink Sheets, had five market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

7. Investors Insurance Group, Inc. ("IIGI") (CIK No. 43340) is a Florida corporation located in West Chester, Pennsylvania with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). IIGI 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, 2003, which reported a net loss of $4,765 for the prior nine months. As of December 15, 2009, the common stock of IIGI was quoted on the Pink Sheets, had five market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

8. ITC Learning Corp. ("ITCC") (CIK No. 764867) is a forfeited Maryland corporation located in Centreville, Virginia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ITCC 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 $700,059 for the prior three months. On July 1, 2002, ITCC filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Eastern District of Virginia, which was converted to a Chapter 7 petition, and was terminated on March 26, 2007. As of December 15, 2009, the common stock of ITCC was quoted on the Pink Sheets, had four market makers, and was eligible for the piggyback exception of Exchange Act Rule 15c2-11(f)(3).

9. Speizman Industries, Inc. ("SPZN") (CIK No. 92827) is a void Delaware corporation located in Charlotte, North Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). SPZN 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 December 27, 2003, which reported a net loss of $2,590,000 for the prior twenty-six weeks. On May 20, 2004, SPZN filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of Georgia which was terminated on February 7, 2008. As of December

15, 2009, the common stock of SPZN 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).

B. DELINQUENT PERIODIC FILINGS

10. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, 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.

11. 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.

12. 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 hereof 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 registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

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, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any 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 permitted by the Commission Rules of Practice.

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

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

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

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Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61191 / December 17, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3082 / December 17, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13720

In the Matter of **RANDY G. FLETCHALL, CPA,** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 4C OF THE EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that that public administrative proceedings be, and hereby are, instituted against Randy G. Fletchall, CPA ("Fletchall" or "Respondent") pursuant to Section 4C[1] of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[2]

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[1] Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

[2] Rule 102(e)(1) provides, in relevant part:

> The Commission may censure a person . . . who is found . . .
>
> * * *
>
> (ii) to have engaged in unethical or improper professional conduct.
>
> * * *

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Section 4C of the Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[3] that:

Summary

1. This matter involves improper professional conduct in 2003 by Fletchall, who was the head of the National Office of Ernst & Young LLP ("E&Y"). Fletchall engaged in a single instance of highly unreasonable conduct with respect to a change of accounting policy by an E&Y audit client, Bally Total Fitness Holding Corporation ("Bally"), in connection with a particular revenue recognition issue. Bally's prior accounting policy for the revenue at issue, which E&Y had audited for years, was clearly not in conformity with accounting principles generally accepted in the United States ("GAAP").

2. In connection with his role in a consultation on the change in Bally's revenue recognition policy, Fletchall did not make sufficient inquiries under circumstances where heightened scrutiny was warranted. Notwithstanding the need for heightened scrutiny, Fletchall failed to exercise due care as required by professional standards.

(iv) with respect to persons licensed to practice as accountants, "improper professional conduct" under Rule 102(e)(1)(ii) means:

* * *

(B) either of the following two types of negligent conduct:

(1) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.

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

Respondent

3. Randy G. Fletchall, age 57, is and was at all relevant times a certified public accountant licensed in Arizona, New York and Texas and a partner at E&Y. Starting in 2001, Fletchall was E&Y's Vice-Chair for Assurance and Advisory Business Services ("AABS") Professional Practice through June 2003, when his title was changed to Vice-Chair, AABS Professional Practice and Risk Management. Fletchall was appointed to E&Y's Americas Executive Board in July 2003.

Other Relevant Entities

4. E&Y is a national public accounting firm and, during the relevant period, served as the independent auditor for Bally.

5. Bally is a Delaware corporation, purported to be the largest, and only nationwide, commercial operator of fitness centers. At all relevant times, Bally's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange ("NYSE"). The NYSE delisted Bally's common stock on June 8, 2007. After filing for reorganization under Chapter 11 of the Bankruptcy Code, on September 17, 2007, Bally emerged as a privately held reorganized entity. On February 28, 2008, the Commission filed a settled injunctive action against Bally in the United States District Court for the District of Columbia, charging Bally with violating Section 17(a) of the Securities Act of 1933, Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. The District Court issued permanent injunctions on May 8, 2008.

Bally's "Reactivation" Revenue Recognition

6. The particular revenue recognition policy about which Fletchall was consulted pertained to Bally's "reactivation" revenue. "Reactivations" were payments from Bally members who had completed their initial contract period, but whose memberships were canceled for failure to pay the monthly dues necessary to maintain their membership. Bally did not attempt to recover those dues because there was no legal obligation to pay such monthly dues. Accordingly, for those canceled members who had completed the initial contract period, Bally waited at least six months after receiving their last monthly dues payment and then began soliciting those canceled members to reactivate. Those who accepted the reactivation offers did so, on average, 36 months after having stopped paying their monthly dues. The reactivation offers did not contain claims for or seek payment of "past due" amounts. Instead, they asked for either a nominal reactivation fee or no reactivation fee at all, and the payment of monthly dues for a period of future service.

7. Bally's reactivation revenue recognition policy was to project (as of the balance sheet date) the reactivation payments it anticipated receiving during the coming year and then immediately recognize most of these projected payments by improperly allocating them to past periods. Bally's reactivation revenue recognition policy was not in conformity with GAAP

because the use of this method enabled Bally to recognize revenue before it was earned and was realized or realizable.[4] Bally recognized revenue before it was earned because, among other things, it barred canceled former members from the gyms, and therefore, had not provided services to those of its canceled members who might reactivate in the future. Additionally, Bally recognized revenue before it was realized or realizable because it was recognizing revenue for reactivations that had not yet occurred, which it anticipated from canceled former members whom it could not identify individually and who had no legal obligation to reactivate or pay Bally anything at all. In short, Bally violated GAAP by recognizing revenue related to the anticipated future payments before the reactivation transactions occurred.

During the Consultation, Fletchall Did Not Exercise Due Care Where Heightened Scrutiny Was Warranted

8. On June 16, 2003, Fletchall received a telephone call from E&Y partners Mark V. Sever, Kenneth W. Peterson, and William J. Carpenter. Sever was the National Director of Area Professional Practice and reported directly to Fletchall. Peterson was the Professional Practice Director for E&Y's Lake Michigan Area office while also serving as the Independent Review Partner on the Bally audit. Carpenter was the Bally audit engagement partner. During this consultation, which lasted 25 minutes, Sever, Peterson and Carpenter requested Fletchall's approval for E&Y to issue a preferability letter concerning Bally's change from recognizing "reactivation" revenue on an accrual basis to recognizing "reactivation" revenue on a cash basis.

9. Under E&Y's internal procedures, approval from the National Office was a mandatory prerequisite to E&Y issuing a preferability letter. In this case, Fletchall determined whether to give National Office approval to issue the preferability letter.

10. A "preferability letter" is issued by an auditor to a client concerning a change in accounting principle. A preferability letter may only be issued when an auditor's client is changing from an accounting principle that is in conformity with GAAP to another accounting principle that is both (a) in conformity with GAAP and (b) is "preferable" to the previously applied principle. A preferability letter may not be issued if the change is from an error, that is, an accounting principle that is not in conformity with GAAP to an accounting principle that is in conformity with GAAP. If an error exists such that a company's previously issued financial statements were not fairly presented, in all material respects, in conformity with GAAP, the auditor is required to insist upon a correction of the error. If the company does not restate its financial statements to correct the error, the auditor must issue a qualified or adverse audit opinion.

11. During the consultation on June 16, 2003, Fletchall did not exercise due care by making sufficient inquiries, despite the fact that heightened scrutiny was warranted in connection

[4] *See, e.g.*, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 1A (1953); Accounting Principles Board Opinion No. 10, Omnibus Opinion (1966); Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (1985); Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, Topic 13A (1999).

with Bally's accounting for reactivations. Fletchall had knowledge of circumstances that warranted heightened scrutiny.

12. First, because he was in charge of risk management efforts for E&Y's AABS practice, Fletchall became aware in the fall of 2002 that, out of E&Y's approximately 10,000 North American clients, Bally was one of E&Y's 18 highest risk clients. He also knew that in 2001 and 2002, a series of widely known financial scandals led E&Y to assess its audit risks and the firm took steps to identify and resign from or focus on certain of its riskiest clients. These 18 riskiest accounts -- including Bally -- were so-called "National Focus Accounts" and were monitored by the Americas Executive Board.

13. Second, Fletchall had been informed previously that Bally's accounting positions were "aggressive." In October 2002, Fletchall was provided with a memorandum regarding E&Y's 2002 client continuance process. An attachment to this memorandum provided additional information about a list of E&Y clients designated for additional attention and stated, among other things, Bally's "CEO and CFO are former [E&Y] partners, have been aggressive in accounting positions, and very focused on meeting or beating Wall Street expectations." Additionally, Sever discussed with Fletchall the list of National Focus Accounts and the reasons why those accounts had been selected as National Focus Accounts.

14. Third, in the course of the consultation about the preferability letter, Sever informed Fletchall that Bally's revenue recognition policy for "reactivations," while in his view GAAP-compliant, was "aggressive."

15. According to the E&Y firm-wide revenue recognition guidance co-issued by Fletchall in 1997, "Aggressive accounting policies or practices" are a "warning signal" that requires E&Y to "carefully evaluate the appropriateness of the client's accounting for the transaction . . . " That guidance further notes that revenue recognition is an area that is particularly susceptible to fraud.

16. Fourth and finally, Fletchall's "first reaction [to the request for a preferability letter] was it seemed a little strange, going from an accrual basis to a cash basis." Under GAAP, accrual accounting is presumptively the proper basis for accounting, and cash basis accounting is presumptively wrong because it is proper under GAAP only when collectibility of amounts owed by customers is not reasonably assured.

<u>Fletchall's Approval of the Preferability Letter Constituted A Single Instance of Highly Unreasonable Conduct in Violation of His Duty to Exercise Due Care in Accordance with Professional Standards</u>

17. Article V of the Principles of Professional Conduct (ET Section 56) requires that an accountant exercise due care when discharging professional responsibilities. Due care requires the accountant to discharge professional responsibilities with competence and diligence. Diligence imposes the responsibility to render services carefully, to be thorough, and to observe applicable technical and ethical standards.

18. Notwithstanding the fact that heightened scrutiny was warranted, Fletchall did not exercise due care. Specifically, he failed to obtain sufficient information that was required for him to: (1) overcome concerns regarding the historical accounting by Bally that should have been raised by the warning signals associated with the proposed accounting change, and (2) determine whether the proposed preferability letter could be issued.

19. With respect to the latter determination, Fletchall failed to exercise due care by conducting sufficient inquiries regarding Bally's prior accounting method. Fletchall was required to understand the current accounting policy, the proposed new accounting policy, and compare the two in order to determine whether the proposed new accounting policy was, indeed, preferable. Second, Fletchall was required to determine if Bally had provided sufficient justification for the change to overcome the "presumption that an accounting principle once adopted should not be changed . . . ." Accounting Principles Board Opinion No. 20, ¶¶ 15 & 16.

20. A reasonable accountant who understood Bally's accrual basis of recognizing revenue for "reactivations" would conclude that it was not in conformity with GAAP, because Bally was recognizing revenue that was not realized or realizable, and had not been earned.

21. Thus, if Fletchall had exercised due care in determining whether to approve E&Y's issuance of the preferability letter, by making sufficient inquiries regarding Bally's accounting for reactivations, he would have concluded that: (1) Bally's current accounting policy was not in conformity with GAAP and was in fact an accounting error; (2) no preferability letter could be issued, and (3) Bally was required to restate its previously issued financial statements to correct that accounting error.

22. Nonetheless, during the call on June 16, 2003, Fletchall reached a "firm conclusion" that cash basis accounting was preferable to accrual basis accounting for recognizing "reactivation" revenue and he gave oral approval to Sever, Peterson, and Carpenter that, subject to the receipt of an acceptable written request for a preferability letter from Bally, E&Y would issue the preferability letter. Fletchall's views did not change when he later received Bally's written request for a preferability letter, and on August 10, 2003, Fletchall gave his written approval to issue the preferability letter.

23. As a result of Bally's failure to correct its improper accounting for reactivations in the appropriate manner, Bally improperly avoided restating its previously issued financial statements and instead improperly recorded a $20.3 million (pre-tax effect) cumulative effect charge to implement a cash basis of accounting for recognizing reactivation revenue.

Findings

Based on the foregoing, Fletchall engaged in improper professional conduct pursuant to Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(1) of the Commission's Rules of Practice. Specifically, the Commission finds Fletchall's failure constitutes a single instance of highly unreasonable conduct that resulted in a violation of professional standards in circumstances in which Fletchall knew or should have known that heightened scrutiny was warranted.

IV.

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

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

Respondent Fletchall is censured pursuant to Rule 102(e)(1) of the Commission's Rules of Practice.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

/

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61195 / December 17, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3086 / December 17, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13724

In the Matter of **THOMAS D. VOGELSINGER, CPA,** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 4C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Thomas D. Vogelsinger, CPA ("Vogelsinger" or "Respondent") pursuant to Sections 4C[1] of the Securities and Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[2]

[1] Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

[2] Rule 102(e)(1) provides, in relevant part, that:

> The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . .
>
> * * *
>
> (ii) to have engaged in unethical or improper professional conduct.
>
> * * *

II.

In anticipation of the institution of these proceedings, Vogelsinger 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, Vogelsinger consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Section 4C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Vogelsinger's Offer, the Commission finds[3] that:

Summary

1. This matter involves improper professional conduct by Vogelsinger during his tenure as the Area Managing Partner of the Lake Michigan Area of Ernst & Young LLP ("E&Y"). The Lake Michigan Area ("LMA") included the Chicago, Grand Rapids and Milwaukee offices. Vogelsinger engaged in repeated instances of unreasonable conduct in failing to detect problems with respect to a revenue recognition policy of an E&Y audit client, Bally Total Fitness Holding Corporation ("Bally"). Bally's prior accounting policy for the revenue at issue, which E&Y had audited for years, was clearly not in conformity with accounting principles generally accepted in the United States ("GAAP").

(iv) with respect to persons licensed to practice as accountants, "improper professional conduct" under §201.102(e)(1)(ii) means:

* * *

(B) either of the following two types of negligent conduct:

* * *

(2) repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

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

2. Vogelsinger did not exercise due care as required by professional standards.[4] Had he done so, he would have discovered that the revenue recognition policy was not in conformity with GAAP.

Respondent

3. Vogelsinger, age 59, was a certified public accountant licensed in Illinois and Iowa during the relevant period. Vogelsinger was the LMA Managing Partner from 2000 until October 2003, and was in charge of E&Y's Chicago, Grand Rapids and Milwaukee offices. He was responsible for overseeing all activities in those offices, including, among others, participating in client continuance decisions and risk management efforts with respect to certain of E&Y's highest risk audit clients. Vogelsinger retired from E&Y in 2009.

Other Relevant Entities

4. E&Y is a national public accounting firm and, during the relevant period covered by this Order, served as the independent auditor for Bally.

5. Bally, a Delaware corporation, purported to be the largest, and only nationwide, commercial operator of fitness centers. At all relevant times, Bally's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange ("NYSE"). The NYSE delisted Bally's common stock on June 8, 2007. After filing for reorganization under Chapter 11 of the Bankruptcy Code, on September 17, 2007, Bally emerged as a privately held reorganized entity. On February 28, 2008, the Commission filed a settled injunctive action against Bally in the United States District Court for the District of Columbia, charging Bally with violating Section 17(a) of the Securities Act of 1933, Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. The District Court issued permanent injunctions on May 8, 2008.

Bally's "Reactivation" Revenue Recognition

6. The particular revenue recognition policy with respect to which Vogelsinger failed to exercise due care pertained to Bally's "reactivation" revenue.

7. Bally recognized revenue from what it called "reactivations," which were payments from Bally members who had completed their initial contract period, but whose memberships were canceled for failure to pay the monthly dues necessary to maintain their membership. Bally did not attempt to recover those dues because there was no legal obligation to pay dues. Accordingly, for those canceled members who had completed the initial contract

[4] Article V of the Principles of Professional Conduct (ET Section 56) requires that an accountant exercise due care when discharging professional responsibilities. Due care requires the accountant to discharge professional responsibilities with competence and diligence. Diligence imposes the responsibility to render services carefully, to be thorough, and to observe applicable technical and ethical standards.

period, Bally waited at least six months after receiving their last payment and then began soliciting those canceled members to reactivate. Those who accepted the reactivation offers did so, on average, 36 months after having stopped paying monthly dues. The reactivation offers did not contain claims for or seek payment of "past due" amounts. Instead, they asked for either a nominal reactivation fee or no reactivation fee at all, and the payment of monthly dues for a period of future service.

8. Bally's reactivation revenue recognition policy was to project (as of the balance sheet date) the reactivation payments it anticipated receiving in the coming year and then immediately recognize most of these projected payments by improperly allocating them to past periods. Bally's reactivation accounting was not in conformity with GAAP because use of the method enabled Bally to recognize revenue before it was earned and was realized or realizable.[5] Bally recognized revenue before it was earned because, among other things, it barred canceled former members from the gyms, and therefore, had not provided services to those of its canceled members who might reactivate in the future. Additionally, Bally recognized revenue before it was realized or realizable because it was recognizing revenue for reactivations that had not yet occurred, which it anticipated from canceled former members whom it could not identify individually and who had no legal obligation to reactivate or pay Bally anything at all.

9. In short, Bally violated GAAP by recognizing revenue related to the anticipated future payments before the reactivation transactions occurred. A reasonable accountant who understood Bally's accrual basis of recognizing revenue for "reactivations" would conclude that it was not in conformity with GAAP, because Bally was recognizing revenue that was not realized or realizable, and had not been earned.

10. For at least six years, E&Y had audited Bally's "reactivation" revenue recognition practices. In each of those years, E&Y provided Bally with an unqualified audit opinion in violation of GAAS.[6]

Vogelsinger's Involvement In E&Y's Risk Management Efforts

11. In 2001 and 2002, a series of widely known financial scandals led E&Y to assess its audit risks and the firm took steps to identify and resign from or focus on certain of its riskiest clients. These 18 riskiest accounts -- including Bally -- were so-called "National Focus Accounts" and were monitored by the Americas Executive Board. Bally was not only identified as a National Focus Account, it was identified as the riskiest account in E&Y's Lake Michigan Area.

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[5] *See, e.g.,* Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins,* Chapter 1A (1953); Accounting Principles Board Opinion No. 10, Omnibus Opinion (1966); Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (1985); Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements,* Topic 13.A (1999).

[6] *See* AICPA's Codification of Auditing Standards AU § 508, *Reports on Audited Financial Statements.*

12. Because of the high risk posed by Bally, and the heightened scrutiny that was warranted for engagements identified as "National Focus Accounts," as the LMA Managing Partner, Vogelsinger was actively involved in helping manage the risk posed to E&Y by Bally. As discussed below, Vogelsinger participated in multiple internal E&Y meetings that focused on the risks presented by the Area and National Focus Accounts, including Bally, and on the steps taken by E&Y to mitigate those risks. Additionally, he participated in two meetings with Bally executives that were intended to improve Bally's accounting and mitigate E&Y's risk.

The 2002 Meetings

13 Beginning in June 2002, Vogelsinger attended meetings with other senior E&Y partners which focused on the risks presented to E&Y by certain audit clients, including Bally, and on the steps taken by E&Y to mitigate those risks.

14 On June 14, 2002, Vogelsinger met to discuss client continuance with, among others, Mark Sever and Kenneth Peterson. Both Sever and Peterson were members of E&Y's National Office. Bally was one of ten high-risk accounts in the Lake Michigan Area that were discussed in that meeting. Among the risks posed by Bally that were discussed at that meeting was Bally's management, which was difficult and engaged in aggressive accounting.

15 On July 16, 2002, Vogelsinger attended another meeting with, among others, Sever, Peterson, and John Kiss, who had been the Bally audit engagement partner since 1996. That meeting likewise focused on the risks presented to E&Y by Bally and on the steps taken by E&Y to mitigate those risks.

16 On September 11, 2002, Vogelsinger had another meeting with Peterson to discuss Bally's risks.

17 On October 28, 2002, Vogelsinger, Peterson, Sever, and Kiss met again to discuss mitigating Bally's risks. Those risks concerned Bally's management, which engaged in "aggressive" accounting with respect to accounting policies and estimates. Among the topics discussed was Bally's accounting for reactivations.

18 By January 2003, E&Y was contemplating resigning from Bally "due to risk issues." Ultimately, Vogelsinger and other senior E&Y partners decided not to resign. That decision was made at a meeting on March 6, 2003.

The March 6, 2003 Internal E&Y Meeting

19. On March 6, 2003, Vogelsinger met with, among others, Sever, Peterson, and Kiss. The subject of the meeting was whether E&Y should resign as Bally's auditor. Kiss prepared a one-page list of the reasons to retain Bally and the reasons to resign. The participants at the meeting discussed the list of reasons to retain and resign and discussed E&Y's exposure.

Under the heading, "Estimates/Complexity in Business Model," "Reactivations" was listed as one of the reasons to resign.

20. At the end of the discussion, Vogelsinger and the others decided not to resign but to stay on and reduce the firm's risk.

The March 11, 2003 Meeting With Bally's CFO

21. On March 11, 2003, Vogelsinger met privately with Bally CFO John Dwyer, who was a former E&Y audit partner, and delivered a one-page document, the "Terms of Engagement," containing E&Y's conditions for remaining as Bally's auditor. During the meeting, Vogelsinger and Dwyer discussed various accounting issues, but Vogelsinger did not request any information about Bally's reactivation revenue recognition policy.

Selection Of A New Engagement Partner

22. Because Kiss was required to rotate off the Bally account, E&Y needed to designate a new engagement partner for the 2003 audit. Vogelsinger and others identified William J. Carpenter as a suitable successor to Kiss. They selected Carpenter because of his ability to "deliver tough messages."

23. Vogelsinger and the AABS Managing Partner briefed Carpenter about the Bally engagement. They advised him that Bally was considered one of the firm's highest-risk clients. They instructed Carpenter to "fix this situation to reduce the firm's risk."

The June 16, 2003 Meeting Regarding Reactivation Accounting

24. After becoming the new engagement partner, Carpenter focused on reactivations as posing risk to E&Y. Carpenter conferred with other members of the audit team, but remained concerned with Bally's reactivation accounting and had the view that Bally's reactivation accounting was more aggressive than he was willing to accept and he was unwilling to sign off on the financial statements that included the reactivation accrual. Carpenter, Sever, Peterson and Vogelsinger planned a meeting with Bally to demand that the Company change its reactivation accounting.

25. In June 2003, Bally was in the midst of refinancing its debt. E&Y called a meeting for June 16, 2003 at Bally's offices. Bally was represented at that meeting by its senior officers. E&Y was represented at the meeting by Vogelsinger, Carpenter, Peterson, Sever, and Kiss. The presence of Vogelsinger, the managing partner of E&Y's Lake Michigan Area office, was unusual, as was the presence of Sever, who was in charge of all of E&Y's Professional Practice Directors in the United States.

26. Vogelsinger began the meeting by stating that Bally had the most aggressive accounts receivable in E&Y's entire Lake Michigan Area.

27. At that same meeting, E&Y announced that it would not provide Bally with the comfort letter and consent that it needed to complete its debt refinance if Bally continued to recognize reactivation revenue the way it had in the past. Additionally, E&Y offered to permit Bally to write off the reactivation accrual over several quarters, a course of action which is clearly not in conformity with GAAP.

28. By participating in substantive aspects of the engagement, Vogelsinger knew or should have known that the reactivation accounting policy was not in conformity with GAAP; there would be no reason to withhold the comfort letter and consent if such policy was in conformity with GAAP even if it was aggressive; similarly, there would have been no reason to offer to allow Bally to violate GAAP by spreading the write off over several quarters.

29. As discussed above, Vogelsinger did not fulfill his obligation to exercise due care by not requiring the engagement team to take appropriate action concerning E&Y's 2002 and 2003 audits of Bally, despite: (1) having risk management responsibilities; (2) knowing that Bally was one of E&Y's riskiest 18 clients; (3) knowing that Bally's management employed "aggressive" accounting principles and estimates; and (4) knowing that Bally's reactivation revenue recognition policy was one of the issues that led to Bally's identification as one of E&Y's riskiest clients.

Findings

Based on the foregoing, Vogelsinger engaged in improper professional conduct pursuant to Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Commission's Rules of Practice. Specifically, the Commission finds that Vogelsinger engaged in repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards that indicate a lack of competence to practice before the Commission.

IV.

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

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

A. Vogelsinger is denied the privilege of appearing or practicing before the Commission as an accountant pursuant to Rule 102(e)(1)(ii) and Rule 102(e)(1)(iv)(B)(2).

B. After 9 months from the date of this order, Vogelsinger 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 Vogelsinger'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) Vogelsinger, 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) Vogelsinger, 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 Vogelsinger's or the firm's quality control system that would indicate that Vogelsinger will not receive appropriate supervision;

(c) Vogelsinger 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) Vogelsinger acknowledges his responsibility, as long as Vogelsinger 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 Vogelsinger 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 Vogelsinger's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

December 17, 2009

In the Matter of

American Sports Development Group, Inc.,
Cybernet Internet Services International, Inc.,
Cyper Media, Inc.,
Frisby Technologies, Inc.,
Graphco Holdings Corp.,
Investors Insurance Group, Inc.,
ITC Learning Corp., and
Speizman Industries, 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 American Sports Development Group, Inc. because it has not filed any periodic reports since the period ended December 31, 2003.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Cybernet Internet Services International, Inc. because it has not filed any periodic reports since the period ended September 30, 2003.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Cyper Media, Inc. because it has not filed any periodic reports since the period ended March 31, 2004.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Frisby Technologies, Inc. because it has not filed any periodic reports since the period ended September 30, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Graphco Holdings Corp. because it has not filed any periodic reports since the period ended September 30, 2003.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Investors Insurance Group, Inc. because it has not filed any periodic reports since the period ended September 30, 2003.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of ITC Learning Corp. because it has not filed any periodic reports since the period ended March 31, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Speizman Industries, Inc. because it has not filed any periodic reports since the period ended December 27, 2003.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EST on December 17, 2009, through 11:59 p.m. EST on December 31, 2009.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9092 / December 17, 2009

SECURITIES EXCHANGE ACT OF 1934
Release No. 61190 / December 17, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3081 / December 17, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13719

In the Matter of WILLIAM J. CARPENTER, CPA Respondent.	ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), and Rule 102(e)(1)(ii) of the Commission's Rules of Practice[2] against William J. Carpenter ("Carpenter" or "Respondent").

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[1] Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

[2] Rule 102(e)(1) provides, in relevant part, that:

> The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . .

II.

In anticipation of the institution of these proceedings, Carpenter 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, Carpenter consents to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 4C and 21C of the Securities Exchange Act of 1934, and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Carpenter's Offer, the Commission finds[3] that:

Summary

1. This matter involves violations of the federal securities laws and improper professional conduct by Carpenter in connection with the 2003 audit of Bally Total Fitness Holding Corporation ("Bally") conducted by Ernst & Young LLP ("E&Y"). Carpenter served as the engagement partner for the 2003 audit.

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(ii) to have engaged in unethical or improper professional conduct.

* * *

(iv) With respect to persons licensed to practice as accountants, "improper professional conduct" under §201.102(e)(1)(ii) means:

* * *

(B) Either of the following two types of negligent conduct:

* * *

(2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

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

2. In connection with Bally's 2003 financial statements, Bally engaged in fraudulent financial accounting, including implementing two improper changes in accounting method rather than restating for accounting errors. On November 30, 2005, Bally filed its 2004 Form 10-K, which restated its previously reported financial statements for 2002 and 2003, and selected financial data for 2000 and 2001.

3. Carpenter knew or should have known that E&Y's unqualified audit opinion regarding Bally's 2003 financial statements, which stated that E&Y had conducted its audits in accordance with auditing standards generally accepted in the United States ("GAAS") and that Bally's financial statements were presented in conformity with accounting principles generally accepted in the United States ("GAAP") – was false because E&Y's audit of Bally's 2003 financial statements was not performed in accordance with GAAS and Bally's financial statements were not in conformity with GAAP.

4. As a result of the false and misleading audit opinion, Carpenter was a cause of Bally's violations of Sections 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13.

Respondent

5. Carpenter is, and was at all relevant times, a Certified Public Accountant licensed in Illinois. Carpenter also served as the engagement partner on the Bally audit from the first quarter 2003 through the first quarter 2004. Carpenter retired from E&Y in 2009.

Issuer

6. Bally, a Delaware corporation, purported to be the largest, and only nationwide, commercial operator of fitness centers. At all relevant times, Bally's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange ("NYSE"). The NYSE delisted Bally's common stock on June 8, 2007. After filing for reorganization under Chapter 11 of the Bankruptcy Code, on September 17, 2007, Bally emerged as a privately held reorganized entity. On February 28, 2008, the Commission filed a settled injunctive action against Bally in the United States District Court for the District of Columbia, charging Bally with violating Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. The District Court issued permanent injunctions on May 8, 2008.

Background

7. For many years up until it resigned in 2004, E&Y audited Bally's financial statements. Bally's principal source of revenue was selling gym membership contracts, which provided customers access to gyms in exchange for the payment of both a one-time initiation fee and monthly dues. The one-time fee was typically several thousand dollars, while the monthly dues typically were less than $10 per month. Most of Bally's customers financed their initiation

fees. To maintain their memberships, customers were required to pay their initiation fee in full and pay monthly dues. The initiation fees were Bally's biggest source of revenue. The obligation to pay the initiation fee was legally enforceable; there was no legal obligation to pay monthly dues beyond the initial contract period.

8. E&Y recognized Bally as a risky audit and, from at least 1996 through 2003, designated Bally as a "close monitoring" account because Bally presented a risk that created "a significant chance the firm [E&Y] will suffer damage to its reputation, monetarily, or both." Bally was designated a close monitoring account for several reasons, including, among other things, that Bally's managers were former E&Y audit partners who were "difficult" and had "historically been aggressive in selecting accounting principles and determining estimates;" the managers placed undue emphasis on maintaining stock prices; management used "(un)reliable . . . estimation process[es] or questionable judgments;" and Bally's compensation plans placed undue emphasis on reported earnings. E&Y's internal guidance notes that a "history of 'aggressive' applications of accounting policies could indicate a predisposition to misstate the financial statements."

9. In early 2002, E&Y sought to reduce its risk by identifying its riskiest clients and resigning from them or otherwise managing the risk they presented to E&Y. Out of a total of over 10,000 audit clients in North America, E&Y identified Bally as one of the riskiest 18 accounts. These 18 accounts were so-called "National Focus Accounts" and were monitored by the Americas Executive Board. Not only was Bally identified as a National Focus Account, it was identified by E&Y as the riskiest account in E&Y's Lake Michigan Area (LMA), based in Chicago.

Bally's Accounting Errors And E&Y's Audit Failures Relating To Fiscal Years 2001 And 2002

10. In connection with fiscal years 2001 and 2002, as well as earlier years, Bally engaged in certain practices relating to its recognition of reactivation revenue, initiation fee revenue, and deferred costs that made its financial statements false and misleading. E&Y issued unqualified audit opinions in connection with its audits of such financial statements, in violation of GAAS.[4]

Premature Recognition of Reactivation Revenues

11. Bally recognized revenue from what it called "reactivations," which were payments from Bally members who had completed their initial contract period, but whose memberships were canceled for failure to pay the monthly dues necessary to maintain their membership. Bally did not attempt to recover those dues because there was no legal obligation to pay dues. Accordingly, for those canceled members who had completed the initial contract period, Bally waited at least six months after receiving their last payment and then began soliciting these canceled members to reactivate. Those who accepted the reactivation offers did

[4] *See* AICPA's Codification of Auditing Standards AU § 508, *Reports on Audited Financial Statements.*

so, on average, 36 months after having stopped paying monthly dues. The reactivation offers did not contain claims for or seek payment of "past due" amounts. Instead, they asked for either a nominal reactivation fee or no reactivation fee at all, and the payment of monthly dues for a period of future service.

12. Bally's revenue recognition policy was to project (as of the balance sheet date) the reactivation payments it anticipated receiving in the coming year and then immediately recognize most of these projected payments by improperly allocating them to past periods. Bally's reactivation revenue recognition policy was not in conformity with GAAP because use of the method enabled Bally to recognize revenue before it was earned and was realized or realizable.[5] Bally recognized revenue before it was earned because, among other things, it barred canceled former members from the gyms, and therefore, had not provided services to those of its canceled members who might reactivate in the future. Additionally, Bally recognized revenue before it was realized or realizable because it was recognizing revenue for reactivations that had not yet occurred, which it anticipated from canceled former members whom it could not identify individually and who had no legal obligation to reactivate or pay Bally anything at all.

13. In short, Bally violated GAAP by recognizing revenue related to the anticipated future payments before the reactivation transactions occurred. The accounting was clearly not in conformity with GAAP, and a reasonable accountant who understood Bally's accrual basis of recognizing revenue for "reactivations" would conclude that it was not in conformity with GAAP, because Bally was recognizing revenue that was not realized or realizable, and had not been earned.

14. For at least six years, E&Y had audited Bally's "reactivation" revenue recognition practices. In each of those years, E&Y provided Bally with an unqualified audit opinion.

<u>Premature Recognition Of Initiation Fee Revenue</u>

15. Members paid a substantial initiation fee in connection with new membership contracts. Beginning in 1997, Bally recognized initiation fee revenue over the estimated average membership life, which included an estimate for both the average initial contract period and the average renewal period. Bally computed the weighted average expected membership life to be 22 months for financed memberships and 36 months for cash memberships.

16. Bally's 1997 computations of the weighted average expected membership life were flawed. A cursory inspection of the computations would have revealed these flaws. In 1997, E&Y had checked Bally's arithmetic and suggested some minor adjustments, but failed to test whether Bally's computations produced results that were consistent with reality, and failed to determine that Bally's computation was fundamentally incorrect. The errors in Bally's estimates

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[5] *See, e.g.*, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* ("ARB 43"), Chapter 1A (1953); Accounting Principles Board Opinion No. 10, Omnibus Opinion (1966); Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (1985); Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, Topic 13.A. (1999).

had the effect of understating the average membership life. As a result, Bally's member life estimates improperly accelerated revenue recognition and distorted the economic reality of Bally's business.

17. These errors continued through the relevant period and by recognizing initiation fee revenue from financed contracts over 22 months, Bally improperly recognized revenue before it was earned and realized or realizable in contravention of GAAP.

E&Y Seeks To Reduce Its Risk: 2002-2003

18. In 2001 and 2002, a series of widely-known financial scandals led E&Y to assess its audit risks and the firm took steps to identify and resign from or focus on certain of its riskiest clients. Internally, E&Y was communicating the dangers of retaining high risk clients, but even though E&Y identified Bally as one of its riskiest clients during the 2002 client continuance process, E&Y did not resign from Bally. Instead, E&Y tried to reduce the risk that Bally's accounting practices posed to E&Y by, among other things, insisting for the first time that Bally record the numerous accounting errors that had "historically been [placed by E&Y] on the summary of audit differences."

19. In addition, as a result of the implementation of the "Focus Accounts" program, Bally, its accounting, and its retention as an E&Y client came under scrutiny from E&Y regional and national management. E&Y's National Office actively participated in events relating to Bally's critical accounting issues. From July 2002 through March 2003, E&Y had numerous internal communications and meetings regarding the risks posed by Bally generally, as well as particular risky accounting issues, including, among other things, Bally's revenue recognition estimates. Bally was the subject of a series of meetings with E&Y management, and Bally was placed on a list of National Focus Accounts for Americas Executive Board attention.

Bally's Accounting Errors And E&Y's Audit Failures Relating To Fiscal Year 2003

20. In March 2003, after the 2002 audit had concluded but before the company had filed its 2002 Form 10-K, E&Y contemplated resigning from the Bally engagement "due to risk issues." E&Y decided against resigning in favor of staying on and reducing its risk.

21. Following the decision to remain as Bally's auditor, E&Y selected Carpenter to be the new E&Y audit engagement partner for the Bally audit. Carpenter rotated onto the Bally audit engagement in April 2003. Carpenter had no prior contact with Bally or involvement in the audits of its financial statements.

22. Carpenter was selected because he was experienced and capable of "delivering tough messages." Carpenter was briefed by the LMA Area Managing Partner ("AMP") and the LMA Advisory Business Services Managing Partner ("AABS-MP"). Carpenter was told that Bally was considered one of the Firm's highest risk clients, and was instructed "to fix this situation to reduce the firm's risk."

Recognition Of Reactivation Revenue

23. After becoming the new engagement partner, Carpenter focused on reactivations as posing risk to E&Y. He reviewed a memorandum E&Y had prepared in connection with the FY 2000 audit (the "2000 memo"), which concluded, improperly, that Bally's reactivation revenue accrual "does not appear to be precluded by SAB 101." The memorandum indicated that (a) members who did not pay dues after the initial contract period were barred from the gyms after a grace period, and (b) these members had no legally enforceable obligation to pay dues after the initial contract period or to reactivate their memberships. Carpenter knew or should have known that these facts undermined and contradicted the conclusion that the reactivation accrual "does not appear to be precluded by SAB 101."

24. Carpenter raised a number of questions challenging the 2000 memorandum's reasoning and conclusions, including whether the reactivation dues amount was "fixed and determinable" in light of the 2000 memo's statement that the amount of dues was modified on occasion to entice reactivations. He also questioned how "customer acceptance," a prerequisite of revenue recognition acknowledged in the 2000 memo, could occur if a customer hasn't used Bally's facilities. Carpenter conferred with members of the audit team and PPDs, who informed Carpenter that Bally's historical accounting for reactivation revenue, although in their view GAAP-compliant, was "aggressive." Carpenter remained concerned with Bally's reactivation revenue recognition policy and had the view that Bally's reactivation revenue recognition policy was more aggressive than he was willing to accept as the partner on the engagement.

25. In June 2003, Bally was in the process of refinancing its bank debt through a private debt offering, to be followed by a public exchange offering. In connection therewith, Bally needed E&Y to provide a comfort letter to the underwriters and a consent regarding Bally's use of E&Y's unqualified audit opinion relating to the 2002 audit. E&Y, including Carpenter, told Bally that unless it stopped accruing reactivation revenue, E&Y would not provide those documents, which left Bally with no real alternative but to agree to stop accruing reactivation revenue. Even though a few months earlier E&Y had issued an unqualified audit opinion regarding Bally's 2002 financial statements that included its reactivation revenue accrual, in a June 16, 2003 meeting, E&Y, including Carpenter, demanded that Bally change its reactivation revenue recognition policy. That same day, after Carpenter and two senior E&Y partners, consulted with E&Y's National Office, E&Y agreed to provide Bally with a preferability letter stating that the proposed change in reactivation revenue recognition policy to a cash basis was a more preferable method of accounting for reactivation revenues.

26. In August 2003, Bally sent E&Y a written request for approval of the proposed change in accounting. Under E&Y's internal guidance, Carpenter and other senior E&Y partners were each required to approve the issuance of E&Y's preferability letter. Carpenter did so on August 12, 2003.

27. Carpenter knew or should have known that Bally's change in accounting for reactivation revenues was not, in fact, a change in accounting principle, but rather was a correction of an error that required a restatement because Bally's original accrual methodology was not in conformity with GAAP. A change in accounting can only be used to move from a

GAAP-compliant accounting methodology to a more preferable GAAP-compliant accounting methodology; errors in previously issued financial statements cannot be corrected through an accounting change.[6] Bally's 2003 financial statements, therefore, improperly included a cumulative effect charge of $20.3 million associated with its change in accounting principle when its prior years' financial statements should have been restated. Accordingly, Bally's 2003 financial statements were not presented in conformity with GAAP, yet Carpenter reviewed and authorized E&Y's issuance of an unqualified audit opinion on Bally's 2003 financial statements, in violation of GAAS.

Recognition Of Initiation Fee Revenue

28. For the year-end 2003 audit, E&Y and Carpenter turned their attention to Bally's other accounting estimates, including the member life estimates used in determining the amortization period of initiation fees that Carpenter knew or should have known were not in conformity with GAAP. Carpenter knew that E&Y had repeatedly identified as a "critical accounting policy" Bally's initiation fee revenue recognition methodology. Given the concerns about fraud perpetrated by means of accounting estimates, for the 2003 audit, E&Y planned to focus its attention on Bally's membership revenue recognition methodology.

29. E&Y's audit planning reflected its awareness that Bally had failed to update its member life estimate since 1997 and that the company had ignored both its commitment to the Commission staff to do so and E&Y's repeated recommendations – in 1998, 2001 and 2002 - to do so. Carpenter also knew or should have known that, having failed to obtain from the Company an update of the average renewal period, E&Y had failed to arrive at its own independent estimate. Consistent with its audit planning concerns about Bally's aggressive estimates and the risk of financial fraud, the E&Y engagement team requested that Bally provide support for the member life estimate for the 2003 fiscal year. Despite repeated efforts to obtain the information, Carpenter and E&Y never received the requested support.

30. Rather than continuing to press Bally for support for its complex accounting estimates, at a meeting on January 25, 2004, E&Y, including Carpenter, encouraged Bally to change its complex accounting methods, including initiation fee revenues. E&Y prepared an agenda for the January 2004 meeting with Bally; four of the five agenda items related to identified audit adjustments that subsequently totaled approximately $260 million.

31. At the January 2004 meeting, E&Y, including Carpenter, notified Bally that it would have to take a charge relating to new accounting guidance that Bally had failed to implement during the third quarter of 2003. E&Y also identified three adjustments that Bally would have to book. E&Y made clear that the new accounting guidance would require Bally to apply a modified cash basis of accounting to some of its contracts. As Bally and E&Y discussed the proposed change, Bally's CFO proposed adopting a modified cash basis of accounting for all of the company's membership contracts. Carpenter knew or should have known that the change to a modified cash basis for the rest of Bally's revenue recognition accounting would have the effect of allowing Bally to avoid or at least reduce the significance of some of the charges E&Y

[6] *See* Accounting Principles Board Opinion No. 20, *Accounting Changes.*

had identified. The proposed changes would also subsume some of the prior audit failures relating to initiation fee revenues. Bally changed its accounting and Carpenter and other senior E&Y partners each reviewed and authorized E&Y's issuance of a preferability letter. Carpenter knew or should have known that the preferability letter enabled Bally to improperly avoid a restatement with respect to initiation fee revenue.

32. Bally's change from accrual accounting to a modified cash basis of accounting was not, in fact, a change in accounting principle, but rather involved a correction of an error that required a restatement because Bally's implementation of the deferral method for recognition of initiation fee revenue was not in conformity with GAAP. Accordingly, Bally's 2003 financial statements were not presented in conformity with GAAP, but Carpenter nonetheless reviewed and authorized E&Y's issuance of an unqualified audit opinion on Bally's 2003 financial statements, in violation of GAAS.

E&Y's Audit Was Deficient And Not Performed In Accordance With GAAS

33. E&Y's 2003 audit was deficient and not performed in accordance with GAAS. E&Y and Carpenter failed to obtain sufficient competent evidential matter to support an opinion that Bally's estimates, including the average member life estimates, were reasonable.[7] E&Y told Bally's audit committee that GAAS prescribed certain "mandatory procedures," including: "reviewing accounting estimates for biases that could result in material misstatement due to fiaud, including retrospective review of significant prior year estimates. . . ."

34. E&Y and Carpenter also did not follow up on evidence that Bally's average member life estimates were biased and unsubstantiated.

35. The change in accounting to a modified cash basis resulted in Bally recording a cumulative effect adjustment ("CEA") of more than $441 million, which was much more than the effect of the identified audit adjustments referred to above, but allowed Bally to provide a positive explanation for the effect. Given that a significant amount of the CEA related to how Bally had amortized the initiation fees over a period of less than two years, Carpenter should have, but did not, question how two supposedly GAAP-compliant methodologies resulted in such a material disparity in earnings. If he had followed up, Carpenter would have determined that Bally's prior calculation of the member life estimates was not reasonable and the Company's straight-line amortization of the financed membership initiation fees over a 22-month period was not in conformity with GAAP.

36. Just as E&Y's issuance of a preferability letter with regard to the change in accounting for reactivation dues was improper, so too was its issuance of a preferability letter with regard to the change to a modified cash basis for initiation fees. By the time E&Y began the 2003 audit, Carpenter was aware of the issues associated with the average member life estimate that required vigorous audit procedures, yet he failed to respond adequately.

[7] *See* AU § 326, *Evidential Matter.*

37. Carpenter knew or should have known that Bally's 2003 financial statements were not presented in conformity with GAAP, and he failed to require E&Y to qualify its opinion or issue an adverse opinion as required by GAAS.

Carpenter Knew Or Should Have Known Bally Made Improper Disclosures Concerning The Lack Of Disagreements And Reportable Events With E&Y

38. When an auditor to a public company resigns, Item 304 of Regulation S-K requires both the company and the auditor to disclose whether any "disagreements" or "reportable events" occurred in the two most recent fiscal years or any subsequent interim period. The term "disagreements" is interpreted broadly, to include any difference of opinion concerning any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures which (if not resolved to the former auditor's satisfaction) would have caused it to make reference to the issue in its audit opinion. The term "reportable events" includes events such as the auditor having advised the company that it questions the reliability of (1) the company's financial statements, (2) management's representations, or (3) the company's internal controls. Item 304 also requires the former auditor to file a letter stating whether it agrees with the company's Item 304 disclosures and, if not, stating the areas of disagreement.

39. In March 2004, Carpenter, and other senior E&Y partners, including the Director of the Professional Practice Group, participated in a meeting during which they decided to resign as Bally's auditor. A memorandum prepared by Carpenter for the meeting, and given to others to review and comment prior to the meeting, identified reasons for resigning, including the engagement team's distrust of Bally's senior financial management; its concerns regarding the company's internal controls and accuracy of accounting records and the accuracy of management's accounting estimates. In addition, Carpenter knew of contentious discussions with Bally's management over various issues, including E&Y's demand that Bally end its practice of recognizing revenue from reactivations that Bally projected would occur in the future.

40. Following the internal E&Y meeting, E&Y, including Carpenter, advised Bally's Audit Committee that it would resign from the engagement because of concerns regarding management's tone, the company's need to demonstrate more concern regarding internal control issues and the accuracy of its accounting records, and the accuracy of management's estimates.

41. In Bally's 2003 Form 10-K disclosure, the Company announced E&Y's resignation but represented that there were no disagreements or reportable events. Similarly, E&Y filed a letter with the Commission stating that it agreed with Bally's statements there had been no disagreements or reportable events with Bally's management.

42. The events described above reflect "disagreements" and "reportable events" that were required to be disclosed under Item 304 of Regulation S-K. Carpenter knew or should have known that these disagreements and reportable events were required to be disclosed, but did not object to the representations in Bally's 2003 Form 10-K stating there had been no "disagreements" or "reportable events;" or prevent E&Y from issuing a letter agreeing with the Company's Item 304 disclosures.

Violations

43. Section 17(a)(2) of the Securities Act prohibits obtaining money or property by means of untrue statements of material fact or misleading omissions of material fact in the offer or sale of securities. Section 17(a)(3) of the Securities Act prohibits engaging in transactions, practices or courses of business which operate or would operate as a fraud or deceit upon the purchaser in the offer or sale of securities. Information is material where there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Establishing violations of Section 17(a)(2) and 17(a)(3) does not require a showing of scienter. *Aaron v. SEC*, 446 U.S. 680, 697 (1980).

44. Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11 and 13a-13 thereunder require all issuers with securities registered under Section 12 of the Exchange Act to file annual, current and quarterly reports on Form 10-K, Form 8-K and Form 10-Q, respectively. Exchange Act Rule 12b-20 further requires that, in addition to the information expressly required to be included in such reports, the issuer must include such additional material information as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading. The obligation to file these periodic reports includes the obligation that they be complete and accurate in all material respects. *See, e.g., SEC v. IMC Int'l, Inc.*, 384 F. Supp. 889, 893 (N.D. Tex.), *aff'd mem.*, 505 F.2d 733 (5^{th} Cir. 1974). No showing of scienter is necessary to establish a violation of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13 and 12b-20. *See SEC v. McNulty*, 137 F.3d 732, 740-741 (2d Cir. 1998).

45. Section 13(b)(2)(A) of the Exchange Act requires issuers to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."

46. Bally violated Section 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder by, among other things, prematurely recognizing income and improperly deferring costs which resulted in its books and records being false, failing to maintain accurate books and records, and including misleading financial statements and information in annual, quarterly and current reports filed with the Commission in connection with fiscal years 2001 through 2003.

47. Carpenter was a cause of Bally's violations. For 2003, Carpenter reviewed and authorized E&Y's issuance of an audit report containing unqualified opinions stating that E&Y had conducted an audit of the company's annual financial statements in accordance with GAAS and that Bally's financial statements were presented in conformity with GAAP. This audit report was included in Bally's Forms 10-K for 2003. However, Carpenter knew or should have known that E&Y's audit report was false and misleading because E&Y failed to conduct the 2003 audit in accordance with GAAS and Bally was engaged in accounting practices and disclosures that were not in conformity with GAAP.

48. In auditing Bally's accounting practices relating to reactivation revenue and initiation fee revenue, Carpenter failed under GAAS to exercise due professional care and skepticism, failed to obtain sufficient competent evidential matter, and substituted managements' representations for competent evidence supporting the accounting. Carpenter never insisted that Bally provide support for certain of these estimates, nor did Carpenter perform sufficient audit procedures to test and determine whether these accounting actions resulted in appropriate recognition of revenue. Had he done so, he would have reasonably determined that these accounting practices were not in conformity with GAAP.

49. Despite these accounting and audit failures, and in further violation of GAAS, Carpenter did not require E&Y to express a qualified or adverse audit opinion, or refuse by disclaimer to express any opinion at all, but instead issued audit reports that contained an unqualified opinion on Bally's 2003 financial statements. Carpenter also knew or should have known that Bally was making false and misleading disclosures. Nor did Carpenter propose that Bally correct its improper accounting in the quarterly financial statements that E&Y reviewed during 2003. Carpenter also reviewed and authorized E&Y's issuance of preferability letters that allowed Bally to switch its accounting policies for reactivation revenue and initiation fee revenue instead of restating for errors relating to that accounting.

50. Accordingly, Carpenter's failure to comply with GAAS was a cause of Bally's violations of Section 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder.

Findings

As a result of the conduct described above, Carpenter engaged in improper professional conduct through repeated instances of unreasonable conduct pursuant to Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Commission's Rules of Practice, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission. Carpenter also was a cause of Bally's violations of Sections 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder.

IV.

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

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

A. Carpenter cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act, and from causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder;

B. Carpenter is denied the privilege of appearing or practicing before the Commission as an accountant pursuant to Rule 102(e)(1)(ii) and Rule 102(e)(1)(iv)(B)(2);

C. After 2 years from the date of this order, Carpenter 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 Carpenter'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) Carpenter, 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) Carpenter, 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 Carpenter's or the firm's quality control system that would indicate that Carpenter will not receive appropriate supervision;

(c) Carpenter 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) Carpenter acknowledges his responsibility, as long as Carpenter 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 Carpenter 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 Carpenter's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Aguilar
not participating

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9093 / December 17, 2009

SECURITIES EXCHANGE ACT OF 1934
Release No. 61192 / December 17, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3083 / December 17, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13721

In the Matter of KENNETH W. PETERSON, CPA, Respondent.	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), and Rule 102(e)(1)(ii) of the Commission's Rules of Practice[2] against Kenneth W. Peterson ("Peterson" or "Respondent").

[1] Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

[2] Rule 102(e)(1) provides, in relevant part, that:

> The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . .

II.

In anticipation of the institution of these proceedings, Peterson 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, Peterson consents to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 4C and 21C of the Securities Exchange Act of 1934, and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Peterson's Offer, the Commission finds[3] that:

Summary

1. This matter involves violations of the federal securities laws and improper professional conduct by Peterson in connection with the 2001-2003 audits of Bally Total Fitness Holding Corporation ("Bally") conducted by Ernst & Young LLP ("E&Y"). Peterson, a Professional Practice Director ("PPD") in E&Y's National Office, served as the Independent Review Partner ("IRP"), or concurring partner, for the 2001-2003 audits.

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(ii) to have engaged in unethical or improper professional conduct.

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(iv) With respect to persons licensed to practice as accountants, "improper professional conduct" under §201.102(e)(1)(ii) means:

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(B) Either of the following two types of negligent conduct:

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(2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

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

2. In connection with Bally's 2001-2003 financial statements, Bally engaged in fraudulent financial accounting, including prematurely recognizing revenue and improperly deferring costs, which overstated income and inflated stockholders' equity, and implementing two improper changes in accounting method rather than restating for accounting errors. Bally also made false and misleading disclosures regarding a $55 million special charge in its 2002 Form 10-K. On November 30, 2005, Bally filed its 2004 Form 10-K, which restated its previously reported financial statements for 2002 and 2003, and selected financial data for 2000 and 2001.

3. Peterson knew or should have known that E&Y's unqualified audit opinions regarding Bally's 2001-2003 financial statements -- which stated that E&Y had conducted its audits in accordance with auditing standards generally accepted in the United States ("GAAS") and that Bally's financial statements were presented in conformity with accounting principles generally accepted in the United States ("GAAP") -- were false because E&Y's audits of Bally's financial statements were not performed in accordance with GAAS and Bally's financial statements were not in conformity with GAAP.

4. As a result of the false and misleading audit opinions, Peterson was a cause of Bally's violations of Sections 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13. Peterson also was a cause of E&Y's violation of Section 10A(b) of the Exchange Act by not ensuring that E&Y brought to the attention of Bally's Audit Committee Bally's false and misleading disclosures of the $55 million special charge.

Respondent

5. Peterson is, and was at all relevant times, a Certified Public Accountant licensed in Illinois. During the relevant period, Peterson was the Professional Practice Director for the Lake Michigan Area and was based in E&Y's Chicago office. Peterson also served as the IRP on the Bally audits from the fourth quarter 2001 through the first quarter 2004 review.

Issuer

6. Bally, a Delaware corporation, purported to be the largest, and only nationwide, commercial operator of fitness centers. At all relevant times, Bally's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange ("NYSE"). The NYSE delisted Bally's common stock on June 8, 2007. After filing for reorganization under Chapter 11 of the Bankruptcy Code, on September 17, 2007, Bally emerged as a privately held reorganized entity. On February 28, 2008, the Commission filed a settled injunctive action against Bally in the United States District Court for the District of Columbia, charging Bally with violating Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. The District Court issued permanent injunctions on May 8, 2008.

Background

7. For many years up until it resigned in 2004, E&Y audited Bally's financial statements. Bally's principal source of revenue was selling gym membership contracts, which provided customers access to gyms in exchange for the payment of both a one-time initiation fee and monthly dues. The one-time fee was typically several thousand dollars, while the monthly dues typically were less than $10 per month. Most of Bally's customers financed their initiation fees. To maintain their memberships, customers were required to pay their initiation fee in full and pay monthly dues. The initiation fees were Bally's biggest source of revenue. The obligation to pay the initiation fee was legally enforceable; there was no legal obligation to pay monthly dues beyond the initial contract period.

8. E&Y recognized Bally as a risky audit and, from at least 1996 through 2003, designated Bally as a "close monitoring" account because Bally presented a risk that created "a significant chance the firm [E&Y] will suffer damage to its reputation, monetarily, or both." Bally was designated a close monitoring account for several reasons, including, among other things, that Bally's managers were former E&Y audit partners who were "difficult" and had "historically been aggressive in selecting accounting principles and determining estimates;" the managers placed undue emphasis on maintaining stock prices; management used "(un)reliable . . . estimation process[es] or questionable judgments;" and Bally's compensation plans placed undue emphasis on reported earnings. E&Y's internal guidance notes that a "history of 'aggressive' applications of accounting policies could indicate a predisposition to misstate the financial statements."

9. In early 2002, E&Y sought to reduce its risk by identifying its riskiest clients and resigning from them or otherwise managing the risk they presented to E&Y. Out of a total of over 10,000 audit clients in North America, E&Y identified Bally as one of the riskiest 18 accounts. These 18 accounts were so-called "National Focus Accounts" and were monitored by the Americas Executive Board. Not only was Bally identified as a National Focus Account, it was identified by Peterson as the riskiest account in E&Y's Lake Michigan Area.

Bally's Accounting Errors And E&Y's Audit Failures Relating To Fiscal Years 2001 And 2002

10. In connection with fiscal years 2001 and 2002, as well as earlier years, Bally engaged in certain practices relating to its recognition of reactivation revenue, initiation fee revenue, and deferred costs that made its financial statements false and misleading. Peterson, who knew or should have known of these practices, and other E&Y partners each reviewed and authorized E&Y's issuance of unqualified audit opinions, in violation of GAAS, in connection with its audits of such financial statements.

Premature Recognition Of Reactivation Revenues

11. Bally recognized revenue from what it called "reactivations," which were payments from Bally members who had completed their initial contract period, but whose memberships were canceled for failure to pay the monthly dues necessary to maintain their

membership. Bally did not attempt to recover those dues because there was no legal obligation to pay dues. Accordingly, for those canceled members who had completed the initial contract period, Bally waited at least six months after receiving their last payment and then began soliciting these canceled members to reactivate. Those who accepted the reactivation offers did so, on average, 36 months after having stopped paying monthly dues. The reactivation offers did not contain claims for or seek payment of "past due" amounts. Instead, they asked for either a nominal reactivation fee or no reactivation fee at all, and the payment of monthly dues for a period of future service.

12. Bally's reactivation revenue recognition policy was to project (as of the balance sheet date) the reactivation payments it anticipated receiving in the coming year and then immediately recognize most of these projected payments by improperly allocating them to past periods. Bally's reactivation revenue recognition policy was not in conformity with GAAP because use of the method enabled Bally to recognize revenue before it was earned and was realized or realizable.[4] Bally recognized revenue before it was earned because, among other things, it barred canceled former members from the gyms, and therefore, had not provided services to those of its canceled members who might reactivate in the future. Additionally, Bally recognized revenue before it was realized or realizable because it was recognizing revenue for reactivations that had not yet occurred, which it anticipated from canceled former members whom it could not identify individually and who had no legal obligation to reactivate or pay Bally anything at all.

13. In short, Bally violated GAAP by recognizing revenue related to the anticipated future payments before the reactivation transactions occurred. The accounting was clearly not in conformity with GAAP, and a reasonable accountant who understood Bally's accrual basis of recognizing revenue for "reactivations" would conclude that it was not in conformity with GAAP, because Bally was recognizing revenue that was not realized or realizable, and had not been earned.

14. For at least six years, E&Y had audited Bally's "reactivation" revenue recognition practices. In each of those years, E&Y provided Bally with an unqualified audit opinion.

15. Peterson knew or should have known that Bally's accounting policy for reactivation revenues was not in conformity with GAAP, yet he and other E&Y partners each reviewed and authorized E&Y's issuance of unqualified opinions regarding Bally's 2001 and 2002 financial statements in violation of GAAS.[5]

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[4] *See, e.g.*, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* ("ARB 43"), Chapter 1A (1953); Accounting Principles Board Opinion No. 10, Omnibus Opinion (1966); Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (1985); Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, Topic 13.A. (1999) ("SAB 101").

[5] *See* AICPA's Codification of Auditing Standards AU § 508, *Reports on Audited Financial Statements*, ("AU § 508").

Premature Recognition of Initiation Fee Revenue

16. Members paid a substantial initiation fee in connection with new membership contracts. Beginning in 1997, Bally recognized initiation fee revenue over the estimated average membership life, which included an estimate for both the average initial contract period and the average renewal period. Bally computed the weighted average expected membership life to be 22 months for financed memberships and 36 months for cash memberships.

17. Bally's 1997 computations of the weighted average expected membership life were flawed. A cursory inspection of the computations would have revealed these flaws. In 1997, E&Y had checked Bally's arithmetic and suggested some minor adjustments, but failed to test whether Bally's computations produced results that were consistent with reality, and failed to determine that Bally's computation was fundamentally incorrect. The errors in Bally's estimates had the effect of understating the average membership life.. As a result, Bally's member life estimates improperly accelerated revenue recognition and distorted the economic reality of Bally's business.

18. These errors continued through the relevant period. Peterson knew or should have known, that by recognizing initiation fee revenue from financed contracts over 22 months, Bally was improperly recognizing revenue before it was earned and realized or realizable in contravention of GAAP, yet he and other E&Y partners each reviewed and authorized E&Y's issuance of unqualified opinions regarding Bally's 2001 and 2002 financial statements in violation of GAAS.

Deferral Of Member Acquisition Costs

19. Bally deferred certain of its costs associated with acquiring new members and recognized such costs over the same period that it deferred initiation fee revenue.

20. GAAP requires that any costs deferred must be direct and incremental to the acquisition of a new contract or activities directly related to such acquisitions (i.e., they would not have been incurred "but for" the acquisition of the contract). Costs associated with acquiring new members are properly deferrable to the extent that they were direct and incremental to the acquisition of a new member contract, while all other costs must be expensed as incurred.[6] Bally, however, improperly deferred certain costs that were not eligible for deferral.

21. Peterson knew or should have known that Bally was improperly deferring certain member acquisition costs, but he and other E&Y partners each reviewed and authorized E&Y's issuance of unqualified opinions regarding Bally's 2001 and 2002 financial statements in violation of GAAS.

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[6] *See* Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, (Dec. 1986); FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, (Dec. 1990); and SAB 101, Topic 13.A.

E&Y's Audits Were Deficient And Not Performed In Accordance With GAAS

22. E&Y's audits of Bally's reactivation revenues, initiation fee revenues, and deferred acquisition costs were deficient and not performed in accordance with GAAS. As an initial matter, Peterson knew that Bally was a risky client due to, among other things, management's aggressive accounting policies.

23. E&Y prepared a memorandum in connection with the FY 2000 audit (the "2000 memo"), which concluded, improperly, that Bally's reactivation revenue accrual "does not appear to be precluded by SAB 101." The memorandum indicated that (a) members who did not pay dues after the initial contract period were barred from the gyms after a grace period, and (b) these members had no legally enforceable obligation to pay dues after the initial contract period or to reactivate their memberships. Peterson reviewed and approved the memorandum in connection with subsequent audits even though he knew or should have known that these facts undermined and contradicted the conclusion that the reactivation accrual "does not appear to be precluded by SAB 101." Peterson should not have concluded that Bally's reactivation revenue policy was in conformity with GAAP and thus Peterson failed to reasonably assess whether Bally's financial statements were presented in conformity with GAAP, as required by GAAS.

24. Peterson also knew or should have known that part of the rationale contained in the 2000 memo supporting Bally's reactivation revenue policy -- that reactivation revenue was a continuation of the original contract -- was contrary to a representation that Bally had previously made to the Commission staff, in connection with its calculation of the average membership life estimate, that reactivation memberships were "in substance and in form, new contractual arrangements." Peterson did not direct the engagement team to address or resolve Bally's conflicting revenue recognition treatments of reactivation memberships.

25. Initiation fee revenue was the largest component of Bally's revenue. In 1997, Bally had committed to the Commission staff that the company would periodically update its member life estimates. Contrary to that commitment, Bally failed to update its member life estimates throughout the period that E&Y remained its auditor and Peterson remained the IRP.

26. Peterson knew or should have known of Bally's failure to keep that commitment. In fact, E&Y formally requested Bally to update its member life computations in 1998, 2001, and 2002, but Bally never did so. In response to E&Y's 2001 request, Bally asserted that the 1997 calculations were still "an appropriate approximation of the current historical average membership length" because the original calculation constituted a "35-year historical average." In fact, the 1997 calculation did not constitute a 35-year historical average, but reflected an average from a much smaller pool of data. Peterson knew or should have known that Bally's representations regarding the 1997 calculation were false

27. E&Y failed to perform adequate audit procedures with regard to the renewal period estimate and the resulting amortization period.[7] Rather, E&Y simply carried forward the 1997 estimates pertaining to the average renewal period. Peterson knew or should have known

[7] *See* AU § 342, *Auditing Accounting Estimates*.

of E&Y's audit failures. Given the critical nature of this accounting estimate, Peterson's failure to require E&Y to obtain from the Company an update or to arrive at its own independent estimate constitutes a departure from GAAS.

28. Peterson also knew or should have known of Bally's arbitrary and unsupported allocation of various costs to the deferred member acquisition cost pool, but he failed to require E&Y to perform adequate audit procedures with regard to those deferred member acquisition costs.

29. Peterson knew or should have known that Bally's 2001 and 2002 financial statements were not presented in conformity with GAAP, but he failed to require E&Y to qualify its opinion or issue an adverse opinion as required by GAAS.

E&Y Seeks To Reduce Its Risk: 2002-2003

30. In 2001 and 2002, a series of widely-known financial scandals led E&Y to assess its audit risks and the firm took steps to identify and resign from or focus on certain of its riskiest clients. Internally, E&Y was communicating the dangers of retaining high risk clients, but even though E&Y identified Bally as one of its riskiest clients during the 2002 client continuance process, E&Y did not resign from Bally. Instead, E&Y tried to reduce the risk that Bally's accounting practices posed to E&Y by, among other things, insisting for the first time that Bally record the numerous accounting errors that had "historically been [placed by E&Y] on the summary of audit differences."

31. In addition, as a result of the implementation of the "Focus Accounts" program, Bally, its accounting, and its retention as an E&Y client came under scrutiny from E&Y regional and national management. E&Y's National Office, including Peterson, actively participated in events relating to Bally's critical accounting issues. From July 2002 through March 2003, E&Y, including Peterson, had numerous internal communications and meetings regarding the risks posed by Bally generally, as well as particular risky accounting issues, including, among other things, Bally's revenue recognition estimates. Bally was the subject of a series of meetings with E&Y management, including Peterson, and Bally was placed on a list of National Focus Accounts for Americas Executive Board attention. Because of the Focus Account program, Peterson knew of Bally's heightened risk designation and was responsible to engage in heightened risk management efforts.

Peterson Knew Or Should Have Known Bally Made False And Misleading Disclosures Regarding A $55 Million Charge In Fiscal Year 2002

32. As of 2002, Bally's allowance for doubtful accounts ("ADA") had long been on E&Y's list of concerns regarding aggressive accounting. Bally's estimate of the ADA was another area in which management's estimates appeared aggressive. Year in and year out, from 1997 through 2002, Bally consistently used a 41% reserve rate, despite changes in the economy and in market conditions. The resulting ADA was always at the low end of the range that E&Y had deemed to be reasonable.

33. During the third quarter of 2002, Peterson and others at E&Y determined that Bally's collections had deteriorated substantially, and they advised Bally that it needed to increase its ADA in order to cover the shortfall resulting from the deteriorating collections. Bally insisted that no change be made to the ADA until the fourth quarter to allow it time to obtain waivers of debt covenants provisions from Bally's lenders.

34. During the fourth quarter of 2002, Bally agreed to increase its ADA by $55 million and ultimately presented it as a "special charge" in Bally's year-end financial statements. In its 2002 Form 10-K, Bally made false and misleading disclosures regarding the reasons for the charge, and Peterson knew or should have known that the disclosures were improper. The only reason for the charge cited in the Form 10-K was that Bally's estimation was based on an accelerated monetization scenario which would result in collecting less than book value. No mention was made of the deterioration of the collectability of Bally's accounts receivable portfolio, which had been identified by E&Y as requiring Bally to take a charge.

35. The $55 million special charge virtually eliminated Bally's 2002 earnings. Peterson knew or should have known that Bally's disclosures failed to disclose accurately the reasons for the "special charge," yet he and other E&Y partners did not object and each authorized E&Y's issuance of an unqualified audit opinion upon Bally's 2002 financial statements in violation of GAAS.[8] Peterson also failed to require E&Y to tell Bally's Audit Committee about Bally's false and misleading disclosures.

Bally's Accounting Errors And E&Y's Audit Failures Relating To Fiscal Year 2003

36. In March 2003, after the 2002 audit had concluded but before the company had filed its 2002 Form 10-K, E&Y, including Peterson, contemplated resigning from the Bally engagement "due to risk issues." E&Y decided against resigning in favor of staying on and reducing its risk.

37. Following the decision to remain as Bally's auditor, E&Y, in consultation with Peterson, selected the new E&Y audit engagement partner for the Bally audit. The new engagement partner rotated onto the Bally audit engagement in April 2003. The new engagement partner, who was selected because he was experienced and capable of delivering tough messages, was instructed to "fix this situation to reduce the firm's risk."

Recognition Of Reactivation Revenue

38. In June 2003, Bally was in the process of refinancing its bank debt through a private debt offering, to be followed by a public exchange offering. In connection therewith, Bally needed E&Y to provide a comfort letter to the underwriters and a consent regarding Bally's use of E&Y's unqualified audit opinion relating to the 2002 audit. E&Y, including Peterson, told Bally that unless it stopped accruing reactivation revenue, E&Y would not provide those documents, which left Bally with no real alternative but to agree to stop accruing reactivation revenue. Even though a few months earlier E&Y, with Peterson's approval, had

[8] *See* AU § 431, *Adequacy of Disclosure in Financial Statements*; AU § 508.

issued an unqualified audit opinion regarding Bally's 2002 financial statements that included its reactivation revenue accrual, in a June 16, 2003 meeting, E&Y, including Peterson, demanded that Bally change its reactivation revenue recognition policy. That same day, after Peterson and other senior E&Y partners consulted with E&Y's National Office, E&Y agreed to provide Bally with a preferability letter stating that the proposed change in reactivation revenue recognition policy to a cash basis was a more preferable method of accounting for reactivation revenues.

39. In August 2003, Bally sent E&Y a written request for approval of the proposed change in accounting. Under E&Y's internal guidance, Peterson and other E&Y partners each were required to approve the issuance of E&Y's preferability letter. Peterson did so on August 5, 2003.

40. Peterson knew or should have known that Bally's change in accounting for reactivation revenues was not, in fact, a change in accounting principle, but rather was a correction of an error that required a restatement because Bally's original accrual methodology was not in conformity with GAAP. A change in accounting can only be used to move from a GAAP-compliant accounting methodology to a more preferable GAAP-compliant accounting methodology; errors in previously issued financial statements cannot be corrected through an accounting change.[9] Bally's 2003 financial statements, therefore, improperly included a cumulative effect charge of $20.3 million associated with its change in accounting principle when its prior years' financial statements should have been restated. Accordingly, Bally's 2003 financial statements were not presented in conformity with GAAP, yet Peterson and other E&Y partners each reviewed and authorized E&Y's issuance of an unqualified audit opinion on Bally's 2003 financial statements in violation of GAAS.

Recognition Of Initiation Fee Revenue

41. For the year-end 2003 audit, E&Y and Peterson turned their attention to Bally's other accounting estimates, including the member life estimates used in determining the amortization period of initiation fees that Peterson knew or should have known were not in conformity with GAAP. Peterson knew that E&Y had repeatedly identified as a "critical accounting policy" Bally's initiation fee revenue recognition methodology. Given the concerns about fraud perpetrated by means of accounting estimates, for the 2003 audit, E&Y planned to focus its attention on Bally's membership revenue recognition methodology.

42. E&Y's audit planning reflected its awareness that Bally had failed to update its member life estimate since 1997 and that the company had ignored both its commitment to the Commission staff to do so and E&Y's repeated recommendations to do so. Consistent with its audit planning concerns about Bally's aggressive estimates and the risk of financial fraud, E&Y requested that Bally provide support for the member life estimate for the 2003 fiscal year. Despite repeated efforts to obtain the information, E&Y never received the requested support.

43. Rather than continuing to press Bally for support for its complex accounting estimates, at a meeting on January 25, 2004, E&Y, including Peterson, encouraged Bally to

[9] *See* APB Opinion No. 20, *Accounting Changes.*

change its complex accounting methods, including initiation fee revenues. E&Y prepared an agenda for the January 2004 meeting with Bally; four of the five agenda items related to identified audit adjustments that subsequently totaled approximately $260 million.

44. At the January 2004 meeting, E&Y, including Peterson, notified Bally that it would have to take a charge relating to new accounting guidance that Bally had failed to implement during the third quarter of 2003. E&Y also identified three adjustments that Bally would have to book. E&Y made clear that the new accounting guidance would require Bally to apply a modified cash basis of accounting to some of its contracts. As Bally and E&Y discussed the proposed change, Bally's CFO proposed adopting a modified cash basis of accounting for all of the company's membership contracts. Peterson knew or should have known that the change to a modified cash basis for the rest of Bally's revenue recognition accounting would have the effect of allowing Bally to avoid or at least reduce the significance of some of the charges E&Y had identified. The proposed changes would also subsume some of the prior audit failures relating to initiation fee revenues. Bally changed its accounting and Peterson and other E&Y partners each reviewed and authorized E&Y's issuance of a preferability letter. Peterson knew or should have known that the preferability letter enabled Bally to improperly avoid a restatement with respect to initiation fee revenue.

45. Bally's change from accrual accounting to a modified cash basis of accounting was not, in fact, a change in accounting principle, but rather involved a correction of an error that required a restatement because Bally's implementation of the deferral method for recognition of initiation fee revenue was not in conformity with GAAP. Accordingly, Bally's 2003 financial statements were not presented in conformity with GAAP, but Peterson nonetheless reviewed and authorized E&Y's issuance of an unqualified audit opinion on Bally's 2003 financial statements in violation of GAAS.

E&Y's Audit Was Deficient And Not Performed In Accordance With GAAS

46. E&Y's 2003 audit was deficient and not performed in accordance with GAAS. E&Y and Peterson failed to obtain sufficient competent evidential matter to support an opinion that Bally's estimates, including the average member life estimates, were reasonable.[10] E&Y told Bally's audit committee that GAAS prescribed certain "mandatory procedures," including: "reviewing accounting estimates for biases that could result in material misstatement due to fraud, including retrospective review of significant prior year estimates. . . ."

47. E&Y and Peterson also did not follow up on evidence that Bally's average member life estimates were biased and unsubstantiated.

48. The change in accounting to a modified cash basis resulted in Bally recording a cumulative effect adjustment ("CEA") of more than $441 million, which was much more than the effect of the identified audit adjustments referred to above, but allowed Bally to provide a

[10] *See* AU § 230, *Due Professional Care*; AU § 326, *Evidential Matter* ("AU § 326"); AU § 333A, *Management Representations.*

positive explanation for the effect. Given that a significant amount of the CEA related to how Bally had amortized the initiation fees over a period of less than two years, Peterson should have directed the engagement team to question how two supposedly GAAP-compliant methodologies resulted in such a material disparity in earnings. Nonetheless, he failed to do so. If he had followed up, Peterson would have determined that Bally's prior calculation of the member life estimates was not reasonable and the Company's straight-line amortization of the financed membership initiation fees over a 22-month period was not in conformity with GAAP.

49. Just as E&Y's issuance of a preferability letter with regard to the change in accounting for reactivation dues was improper, so too was its issuance of a preferability letter with regard to the change to a modified cash basis for initiation fees. By the time E&Y began the 2003 audit, Peterson knew or should have known of the issues associated with the average member life estimate that required vigorous audit procedures, yet he failed to require E&Y to respond adequately.

50. Peterson knew or should have known that Bally's 2003 financial statements were not presented in conformity with GAAP, and he failed to require E&Y to qualify its opinion or issue an adverse opinion as required by GAAS.

<u>Peterson Knew Or Should Have Known Bally Made Improper Disclosures Concerning The Lack Of Disagreements And Reportable Events With E&Y</u>

51. When an auditor to a public company resigns, Item 304 of Regulation S-K requires both the company and the auditor to disclose whether any "disagreements" or "reportable events" occurred in the two most recent fiscal years or any subsequent interim period. The term "disagreements" is interpreted broadly, to include any difference of opinion concerning any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures which (if not resolved to the former auditor's satisfaction) would have caused it to make reference to the issue in its audit opinion. The term "reportable events" includes events such as the auditor having advised the company that it questions the reliability of (1) the company's financial statements, (2) management's representations, or (3) the company's internal controls. Item 304 also requires the former auditor to file a letter stating whether it agrees with the company's Item 304 disclosures and, if not, stating the areas of disagreement.

52. In March 2004, Peterson, and other senior E&Y partners, including the Engagement Partner, and the Director of the Professional Practice Group, participated in a meeting during which they decided to resign as Bally's auditor. A memorandum prepared by the Engagement Partner for the meeting, and given to Peterson and others to review and comment prior to the meeting, identified reasons for resigning, including the engagement team's distrust of Bally's senior financial management; its concerns regarding the company's internal controls and accuracy of accounting records and the accuracy of management's accounting estimates. In addition, Peterson knew of contentious discussions with Bally's management over various issues, including E&Y's demand that Bally end its practice of recognizing revenue from reactivations that Bally projected would occur in the future.

53. Following the internal E&Y meeting, E&Y advised Bally's Audit Committee that it would resign from the engagement because of concerns regarding management's tone, the company's need to demonstrate more concern regarding internal control issues and the accuracy of its accounting records, and the accuracy of management's estimates.

54. In Bally's 2003 Form 10-K disclosure, the Company announced E&Y's resignation but represented that there were no disagreements or reportable events. Similarly, E&Y filed a letter with the Commission stating that it agreed with Bally's statements there had been no disagreements or reportable events with Bally's management.

55. The events described above reflect "disagreements" and "reportable events" that were required to be disclosed under Item 304 of Regulation S-K. Peterson knew or should have known that these disagreements and reportable events were required to be disclosed, but did not object to the representations in Bally's 2003 Form 10-K stating there had been no "disagreements" or "reportable events;" or prevent E&Y from issuing a letter agreeing with the Company's Item 304 disclosures.

Violations

56. Section 17(a)(2) of the Securities Act prohibits obtaining money or property by means of untrue statements of material fact or misleading omissions of material fact in the offer or sale of securities. Section 17(a)(3) of the Securities Act prohibits engaging in transactions, practices or courses of business which operate or would operate as a fraud or deceit upon the purchaser in the offer or sale of securities. Information is material where there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Establishing violations of Section 17(a)(2) and 17(a)(3) does not require a showing of scienter. *Aaron v. SEC*, 446 U.S. 680, 697 (1980).

57. Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11 and 13a-13 thereunder require all issuers with securities registered under Section 12 of the Exchange Act to file annual, current and quarterly reports on Form 10-K, Form 8-K and Form 10-Q, respectively. Exchange Act Rule 12b-20 further requires that, in addition to the information expressly required to be included in such reports, the issuer must include such additional material information as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading. The obligation to file these periodic reports includes the obligation that they be complete and accurate in all material respects. *See, e.g., SEC v. IMC Int'l, Inc.*, 384 F. Supp. 889, 893 (N.D. Tex.), aff'd mem., 505 F.2d 733 (5th Cir. 1974). No showing of scienter is necessary to establish a violation of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13 and 12b-20. *See SEC v. McNulty*, 137 F.3d 732, 740-741 (2d Cir. 1998).

58. Section 13(b)(2)(A) of the Exchange Act requires issuers to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."

59. Bally violated Section 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder by, among other things, prematurely recognizing income and improperly deferring costs which resulted in its books and records being false, failing to maintain accurate books and records and including misleading financial statements and information in annual, quarterly and current reports filed with the Commission in connection with fiscal years 2001 through 2003.

60. Peterson was a cause of Bally's violations. For each of the years 2001-2003, Peterson reviewed and authorized E&Y's issuance of audit reports containing unqualified opinions stating that E&Y had conducted an audit of the company's annual financial statements in accordance with GAAS and that Bally's financial statements were presented in conformity with GAAP. These audit reports were included in Bally's Forms 10-K for 2001-2003. However, Peterson knew or should have known that E&Y's audit reports were false and misleading because E&Y failed to conduct its audits in accordance with GAAS and Bally was engaged in accounting practices and disclosures that were not in conformity with GAAP.

61. In auditing Bally's accounting practices relating to reactivation revenue, initiation fee revenue and deferred acquisition costs, Peterson failed under GAAS to exercise due professional care and skepticism, failed to ensure that E&Y obtained sufficient competent evidential matter, and substituted managements' representations for competent evidence supporting the accounting. Peterson failed to insist that Bally provide support for certain of these estimates, nor did Peterson require that the engagement team perform sufficient audit procedures to test and determine whether these accounting actions resulted in appropriate recognition of revenue. Had he done so, he would have reasonably determined that these accounting practices were not in conformity with GAAP.

62. Despite these accounting and audit failures, and in further violation of GAAS, Peterson did not require E&Y to express a qualified or adverse audit opinion, or refuse by disclaimer to express any opinion at all, but instead issued audit reports that contained unqualified opinions on Bally's 2001-2003 financial statements. Peterson also knew or should have known that Bally was making false and misleading disclosures such as in connection with its $55 million special charge. Nor did Peterson propose that Bally correct its improper accounting in the quarterly financial statements that E&Y reviewed during 2001-2003. Peterson also authorized E&Y to improperly issue preferability letters that allowed Bally to switch its accounting policies for reactivation revenue and initiation fee revenue instead of restating for errors relating to that accounting. Accordingly, Peterson's failure to comply with GAAS was a cause of Bally's violations of Section 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder.

63. Peterson also was a cause of E&Y's violation of Section 10A(b) of the Exchange Act in connection with Bally's failure to disclose that the $55 million special charge recorded in

its FY 2002 financial statements was due to a deterioration in the collectability of the Company's receivables. Peterson failed to require E&Y to report this illegal act to the Audit Committee in accordance with Section 10A(b).

Findings

As a result of the conduct described above, Peterson engaged in improper professional conduct through repeated instances of improper professional conduct pursuant to Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B)(2) of the Commission's Rules of Practice and was a cause of Bally's violations of Sections 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. Peterson also was a cause of E&Y's violation of Section 10A(b) of the Exchange Act by not ensuring that E&Y brought to the attention of Bally's Audit Committee Bally's false and misleading disclosures of the $55 million special charge.

IV.

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

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

A. Peterson cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act, and from causing any violations and any future violations of Sections 10A(b), 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder;

B. Peterson is denied the privilege of appearing or practicing before the Commission as an accountant pursuant to Rule 102(e)(1)(ii) and Rule 102(e)(1)(iv)(B)(2);

C. After 2 years from the date of this order, Peterson 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 Peterson'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) Peterson, 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) Peterson, 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 Peterson's or the firm's quality control system that would indicate that the Peterson will not receive appropriate supervision;

(c) Peterson 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) Peterson acknowledges his responsibility, as long as Peterson 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 Peterson 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 Peterson's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9094 / December 17, 2009

SECURITIES EXCHANGE ACT OF 1934
Release No. 61193 / December 17, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3084 / December 17, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13722

In the Matter of **MARK V. SEVER, CPA,** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), and Rule 102(e)(1)(iii) of the Commission's Rules of Practice[2] against Mark V. Sever ("Sever" or "Respondent").

[1] Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

[2] Rule 102(e)(1) provides, in pertinent part, that:

II.

In anticipation of the institution of these proceedings, Sever 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, Sever consents to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 4C and 21C of the Securities Exchange Act of 1934, and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Sever's Offer, the Commission finds[3] that:

Summary

1. This matter involves violations of the federal securities laws and improper professional conduct by Sever in connection with the 2001-2003 audits of Bally Total Fitness Holding Corporation ("Bally") conducted by Ernst & Young LLP ("E&Y"). From 1997 through the third quarter of 2001, Sever was a Professional Practice Director ("PPD") in E&Y's National Office, and served as the Independent Review Partner ("IRP"), or concurring partner, for Bally's audits. Then, as the National Director of Area Professional Practice, who also developed and implemented E&Y's Focus Account risk management program, Sever remained involved with Bally's 2001-2003 audits.

2. In connection with Bally's 2001-2003 financial statements, Bally engaged in fraudulent financial accounting, including prematurely recognizing revenue and improperly deferring costs, which overstated income and inflated stockholders' equity, and implementing two improper changes in accounting method rather than restating for accounting errors. Bally also made false and misleading disclosures regarding a $55 million special charge in its 2002 Form 10-K. On November 30, 2005, Bally filed its 2004 Form 10-K, which restated its

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The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found…

* * *

(iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

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

previously reported financial statements for 2002 and 2003, and selected financial data for 2000 and 2001.

3. Sever knew or should have known that E&Y's unqualified audit opinions regarding Bally's 2001-2003 financial statements -- which stated that E&Y had conducted its audits in accordance with auditing standards generally accepted in the United States ("GAAS") and that Bally's financial statements were presented in conformity with accounting principles generally accepted in the United States ("GAAP") -- were false because E&Y's audits of Bally's financial statements were not performed in accordance with GAAS and Bally's financial statements were not in conformity with GAAP.

4. As a result of the false and misleading audit opinions, Sever was a cause of Bally's violations of Sections 17(a)(2) and (3) of the Securities Act, and was a cause of and willfully[4] aided and abetted Bally's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13. Sever also was a cause of E&Y's violation of Section 10A(b) of the Exchange Act by not ensuring that E&Y brought to the attention of Bally's Audit Committee Bally's false and misleading disclosures of the $55 million special charge.

Respondent

5. Sever is, and was at all relevant times, a Certified Public Accountant licensed in Illinois. From 1997 through the third quarter of 2001, Sever was the PPD for the Lake Michigan Area and also was the IRP on the Bally audits. Sever then was appointed to be the National Director of Area Professional Practice, but he remained involved in Bally's audits.

Issuer

6. Bally, a Delaware corporation, purported to be the largest, and only nationwide, commercial operator of fitness centers. At all relevant times, Bally's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange ("NYSE"). The NYSE delisted Bally's common stock on June 8, 2007. After filing for reorganization under Chapter 11 of the Bankruptcy Code, on September 17, 2007, Bally emerged as a privately held reorganized entity. On February 28, 2008, the Commission filed a settled injunctive action against Bally in the United States District Court for the District of Columbia, charging Bally with violating Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. The District Court issued permanent injunctions on May 8, 2008.

[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)).

Background

7. For many years up until it resigned in 2004, E&Y audited Bally's financial statements. Bally's principal source of revenue was selling gym membership contracts, which provided customers access to gyms in exchange for the payment of both a one-time initiation fee and monthly dues. The one-time fee was typically several thousand dollars, while the monthly dues typically were less than $10 per month. Most of Bally's customers financed their initiation fees. To maintain their memberships, customers were required to pay their initiation fee in full and pay monthly dues. The initiation fees were Bally's biggest source of revenue. The obligation to pay the initiation fee was legally enforceable; there was no legal obligation to pay monthly dues beyond the initial contract period.

8. E&Y recognized Bally as a risky audit and, from at least 1996 through 2003, designated Bally as a "close monitoring" account because Bally presented a risk that created "a significant chance the firm [E&Y] will suffer damage to its reputation, monetarily, or both." Bally was designated a close monitoring account for several reasons, including, among other things, that Bally's managers were former E&Y audit partners who were "difficult" and had "historically been aggressive in selecting accounting principles and determining estimates;" the managers placed undue emphasis on maintaining stock prices; management used "(un)reliable . . . estimation process[es] or questionable judgments;" and Bally's compensation plans placed undue emphasis on reported earnings. E&Y's internal guidance notes that a "history of 'aggressive' applications of accounting policies could indicate a predisposition to misstate the financial statements."

9. In early 2002, E&Y sought to reduce its risk by identifying its riskiest clients and resigning from them or otherwise managing the risk they presented to E&Y. Out of a total of over 10,000 audit clients in North America, E&Y identified Bally as one of the riskiest 18 accounts. These 18 accounts were so-called "National Focus Accounts" and were monitored by the Americas Executive Board. Not only was Bally identified as a National Focus Account, Sever knew it was identified as the riskiest account in E&Y's Lake Michigan Area.

Bally's Accounting Errors And E&Y's Audit Failures Relating To Fiscal Years 2001 And 2002

10. In connection with fiscal years 2001 and 2002, as well as earlier years, Bally engaged in certain practices relating to its recognition of reactivation revenue, initiation fee revenue, and deferred costs that made its financial statements false and misleading. Sever, who knew or should have known of these practices, reviewed and did not object to E&Y's issuance of unqualified audit opinions, in violation of GAAS, in connection with its audits of such financial statements.

Premature Recognition Of Reactivation Revenues

11. Bally recognized revenue from what it called "reactivations," which were payments from Bally members who had completed their initial contract period, but whose memberships were canceled for failure to pay the monthly dues necessary to maintain their

membership. Bally did not attempt to recover those dues because there was no legal obligation to pay dues. Accordingly, for those canceled members who had completed the initial contract period, Bally waited at least six months after receiving their last payment and then began soliciting these canceled members to reactivate. Those who accepted the reactivation offers did so, on average, 36 months after having stopped paying monthly dues. The reactivation offers did not contain claims for or seek payment of "past due" amounts. Instead, they asked for either a nominal reactivation fee or no reactivation fee at all, and the payment of monthly dues for a period of future service.

12. Bally's reactivation revenue recognition policy was to project (as of the balance sheet date) the reactivation payments it anticipated receiving in the coming year and then immediately recognize most of these projected payments by improperly allocating them to past periods. Bally's reactivation revenue recognition policy was not in conformity with GAAP because use of the method enabled Bally to recognize revenue before it was earned and was realized or realizable.[5] Bally recognized revenue before it was earned because, among other things, it barred canceled former members from the gyms, and therefore, had not provided services to those of its canceled members who might reactivate in the future. Additionally, Bally recognized revenue before it was realized or realizable because it was recognizing revenue for reactivations that had not yet occurred, which it anticipated from canceled former members whom it could not identify individually and who had no legal obligation to reactivate or pay Bally anything at all.

13. In short, Bally violated GAAP by recognizing revenue related to the anticipated future payments before the reactivation transactions occurred. The accounting was clearly not in conformity with GAAP, and a reasonable accountant who understood Bally's accrual basis of recognizing revenue for "reactivations" would conclude that it was not in conformity with GAAP, because Bally was recognizing revenue that was not realized or realizable, and had not been earned.

14. For at least six years, E&Y had audited Bally's "reactivation" revenue recognition practices. In each of those years, E&Y provided Bally with an unqualified audit opinion.

15. Sever knew or should have known that Bally's accounting policy for reactivation revenues was not in conformity with GAAP, yet he reviewed and did not object to E&Y's issuance of unqualified opinions regarding Bally's 2001 and 2002 financial statements in violation of GAAS.[6]

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[5] *See, e.g.*, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* ("ARB 43"), Chapter 1A (1953); Accounting Principles Board Opinion No. 10, Omnibus Opinion (1966); Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (1985); Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements,* Topic 13.A. (1999)("SAB 101").

[6] *See* AICPA's Codification of Auditing Standards AU § 508, *Reports on Audited Financial Statements,* ("AU § 508").

Premature Recognition Of Initiation Fee Revenue

16. Members paid a substantial initiation fee in connection with new membership contracts. Beginning in 1997, Bally recognized initiation fee revenue over the estimated average membership life, which included an estimate for both the average initial contract period and the average renewal period. Bally computed the weighted average expected membership life to be 22 months for financed memberships and 36 months for cash memberships.

17. Bally's 1997 computations of the weighted average expected membership life were flawed. A cursory inspection of the computations would have revealed these flaws. In 1997, E&Y had checked Bally's arithmetic and suggested some minor adjustments, but failed to test whether Bally's computations produced results that were consistent with reality, and failed to determine that Bally's computation was fundamentally incorrect. The errors in Bally's estimates had the effect of understating the average membership life. As a result, Bally's member life estimates improperly accelerated revenue recognition and distorted the economic reality of Bally's business.

18. These errors continued through the relevant period. Sever knew or should have known, that by recognizing initiation fee revenue from financed contracts over 22 months, Bally was improperly recognizing revenue before it was earned and realized or realizable in contravention of GAAP, yet he reviewed and did not object to E&Y's issuance of unqualified opinions regarding Bally's 2001 and 2002 financial statements in violation of GAAS.

Deferral Of Member Acquisition Costs

19. Bally deferred certain of its costs associated with acquiring new members and recognized such costs over the same period that it deferred initiation fee revenue.

20. GAAP requires that any costs deferred must be direct and incremental to the acquisition of a new contract or activities directly related to such acquisitions (i.e., they would not have been incurred "but for" the acquisition of the contract). Costs associated with acquiring new members are properly deferrable to the extent that they were direct and incremental to the acquisition of a new member contract, while all other costs must be expensed as incurred.[7] Bally, however, improperly deferred certain costs that were not eligible for deferral.

21. Sever knew or should have known that Bally was improperly deferring certain member acquisition costs, but he reviewed and did not object to E&Y's issuance of unqualified opinions regarding Bally's 2001 and 2002 financial statements in violation of GAAS.

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[7] *See* Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* (Dec. 1986); FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts,* (Dec. 1990); and SAB 101, Topic 13.A.

E&Y's Audits Were Deficient And Not Performed In Accordance With GAAS

22. E&Y's audits of Bally's reactivation revenues, initiation fee revenues, and deferred acquisition costs were deficient and not performed in accordance with GAAS. As an initial matter, Sever knew that Bally was a risky client due to, among other things, management's aggressive accounting policies.

23. E&Y prepared a memorandum in connection with the FY 2000 audit (the "2000 memo"), which concluded, improperly, that Bally's reactivation revenue accrual "does not appear to be precluded by SAB 101." The memorandum indicated that (a) members who did not pay dues after the initial contract period were barred from the gyms after a grace period, and (b) these members had no legally enforceable obligation to pay dues after the initial contract period or to reactivate their memberships. Sever reviewed and approved the memorandum even though he knew or should have known that that these facts undermined and contradicted the conclusion that the reactivation accrual "does not appear to be precluded by SAB 101." Sever should not have concluded that Bally's reactivation revenue policy was in conformity with GAAP and thus Sever failed to reasonably assess whether Bally's financial statements were presented in conformity with GAAP, as required by GAAS.

24. Sever also knew or should have known that part of the rationale contained in the 2000 memo supporting Bally's reactivation revenue policy -- that reactivation revenue was a continuation of the original contract -- was contrary to a representation that Bally had previously made to the Commission staff, in connection with its calculation of the average membership life estimate, that reactivation memberships were "in substance and in form, new contractual arrangements." Sever did not direct the engagement team to address or resolve Bally's conflicting revenue recognition treatments of reactivation memberships.

25. Initiation fee revenue was the largest component of Bally's revenue. In 1997, Bally had committed to the Commission staff that the company would periodically update its member life estimates. Contrary to that commitment, Bally failed to update its member life estimates throughout the period that E&Y remained its auditor and that Sever remained the IRP and subsequently remained involved with the Bally audit.

26. Sever knew or should have known of Bally's failure to keep that commitment. In fact, E&Y formally requested Bally to update its member life computations in 1998, 2001, and 2002, but Bally never did so. In response to E&Y's 2001 request, Bally asserted that the 1997 calculations were still "an appropriate approximation of the current historical average membership length" because the original calculation constituted a "35-year historical average." In fact, the 1997 calculation did not constitute a 35-year historical average, but reflected an average from a much smaller pool of data. Sever knew or should have known that Bally's representations regarding the 1997 calculation were false.

27. E&Y failed to perform adequate audit procedures with regard to the renewal period estimate and the resulting amortization period.[8] Rather, E&Y simply carried forward the

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[8] *See* AU § 342, *Auditing Accounting Estimates*.

1997 estimates pertaining to the average renewal period. Sever knew or should have known of E&Y's audit failures. Given the critical nature of this accounting estimate, Sever's failure to require E&Y to obtain from the Company an update or to arrive at its own independent estimate constitutes a departure from GAAS.

28. Sever also knew or should have known of Bally's arbitrary and unsupported allocation of various costs to the deferred member acquisition cost pool, but he failed to require E&Y to perform adequate audit procedures with regard to those deferred member acquisition costs.

29. Sever knew or should have known that Bally's 2001 and 2002 financial statements were not presented in conformity with GAAP, but he failed to require E&Y to qualify its opinion or issue an adverse opinion as required by GAAS.

E&Y Seeks To Reduce Its Risk: 2002-2003

30. In 2001 and 2002, a series of widely-known financial scandals led E&Y to assess its audit risks and the firm took steps to identify and resign from or focus on certain of its riskiest clients. Internally, E&Y, including Sever, was communicating the dangers of retaining high risk clients, but even though E&Y identified Bally as one of its riskiest clients during the 2002 client continuance process, E&Y did not resign from Bally. Instead, E&Y tried to reduce the risk that Bally's accounting practices posed to E&Y by, among other things, insisting for the first time that Bally record the numerous accounting errors that had "historically been [placed by E&Y] on the summary of audit differences."

31. In addition, during this period, Sever was responsible for developing and implementing E&Y's initiative to identify the firm's highest risk clients. Sever, working with the area PPDs, developed a list of the approximately 18 highest risk accounts. These accounts, including Bally, were identified as National Focus Accounts for Americas Executive Board attention.

32. As a result of the implementation of the "Focus Accounts" program, Bally, its accounting, and its retention as an E&Y client came under scrutiny from E&Y regional and national management. E&Y's National Office, including Sever, actively participated in events relating to Bally's critical accounting issues. From July 2002 through March 2003, E&Y, including Sever, had numerous internal communications and meetings regarding the risks posed by Bally generally, as well as particular risky accounting issues, including, among other things, Bally's revenue recognition estimates. Bally was the subject of a series of meetings with E&Y management, including Sever, and Bally was placed on the list of National Focus Accounts. Despite his position as National Director of Area Professional Practice and his lack of any formal role on the Bally's audits, Sever was heavily involved with Bally's accounting issues in 2002 and 2003.

Sever Knew Or Should Have Known Bally Made False And Misleading Disclosures Regarding A $55 Million Charge In Fiscal Year 2002

33. As of 2002, Bally's allowance for doubtful accounts ("ADA") had long been on E&Y's list of concerns regarding aggressive accounting. Bally's estimate of the ADA was another area in which management's estimates appeared aggressive. Year in and year out, from 1997 through 2002, Bally consistently used a 41% reserve rate, despite changes in the economy and in market conditions. The resulting ADA was always at the low end of the range that E&Y had deemed to be reasonable.

34. During the third quarter of 2002, Sever and others at E&Y determined that Bally's collections had deteriorated substantially, and they advised Bally that it needed to increase its ADA in order to cover the shortfall resulting from the deteriorating collections. Sever also met with both Bally's CFO and CEO to discuss the need to increase Bally's bad debt allowance. Bally insisted that no change be made to the ADA until the fourth quarter to allow it time to obtain waivers of debt covenants provisions from Bally's lenders.

35. During the fourth quarter of 2002, Bally agreed to increase its ADA by $55 million and ultimately presented it as a "special charge" in Bally's year-end financial statements. In its 2002 Form 10-K, Bally made false and misleading disclosures regarding the reasons for the charge, and Sever knew or should have known that the disclosures were improper. The only reason for the charge cited in the Form 10-K was that Bally's estimation was based on an accelerated monetization scenario which would result in collecting less than book value. No mention was made of the deterioration of the collectability of Bally's accounts receivable portfolio, which had been identified by E&Y as requiring Bally to take a charge.

36. The $55 million special charge virtually eliminated Bally's 2002 earnings. Sever knew or should have known that Bally's disclosures failed to disclose accurately the reasons for the "special charge," yet he did not object to E&Y's issuance of an unqualified audit opinion upon Bally's 2002 financial statements in violation of GAAS.[9] Sever also failed to require E&Y to tell Bally's Audit Committee about Bally's false and misleading disclosures.

Bally's Accounting Errors And E&Y's Audit Failures Relating To Fiscal Year 2003

37. In March 2003, after the 2002 audit had concluded but before the company had filed its 2002 Form 10-K, E&Y, including Sever, contemplated resigning from the Bally engagement "due to risk issues." E&Y decided against resigning in favor of staying on and reducing its risk.

38. Following the decision to remain as Bally's auditor, a new E&Y audit engagement partner rotated on to the Bally engagement in April 2003. The new engagement partner, who was selected because he was experienced and capable of delivering tough messages, was instructed to "fix this situation to reduce the firm's risk."

[9] *See* AU § 431, *Adequacy of Disclosure in Financial Statements*; AU § 508.

Recognition Of Reactivation Revenue

39. After the new engagement partner joined the Bally audit team, he reviewed E&Y's prior analysis of Bally's accounting for reactivations, the 2000 audit file memo that Sever had approved, and raised a number of questions challenging its reasoning. The new engagement partner consulted with Sever and the former engagement partner, but the new engagement partner remained concerned about whether Bally's reactivation revenue recognition policy was in conformity with GAAP.

40. In June 2003, Bally was in the process of refinancing its bank debt through a private debt offering, to be followed by a public exchange offering. In connection therewith, Bally needed E&Y to provide a comfort letter to the underwriters and a consent regarding Bally's use of E&Y's unqualified audit opinion relating to the 2002 audit. E&Y, including Sever, told Bally that unless it stopped accruing reactivation revenue, E&Y would not provide those documents, which left Bally with no real alternative but to agree to stop accruing reactivation revenue.

41. Even though a few months earlier E&Y had issued an unqualified audit opinion regarding Bally's 2002 financial statements that included its reactivation revenue accrual, in a June 16, 2003 meeting, E&Y, including Sever, demanded that Bally change its reactivation revenue recognition policy. Initially, Sever suggested that Bally write off the reactivation accrual in that quarter or over the next several quarters. Neither alternative was in conformity with GAAP: the $20.3 million reactivation accrual could not be written off in one quarter because a material error requires a restatement under Accounting Principles Board Opinion No. 20, *Accounting Changes*; and the $20.3 million was material to Bally's income statement. Similarly, spreading of the write-off of an error over several quarters is not in conformity with GAAP.

42. In the same June 16, 2003 meeting, the issue of a preferability letter was then raised. That same day, after Sever and other senior E&Y partners consulted with the head of E&Y's National Office, E&Y agreed to provide Bally with a preferability letter stating that the proposed change in reactivation revenue recognition policy to a cash basis was a more preferable method of accounting for reactivation revenues.

43. In August 2003, Bally sent E&Y a written request for approval of the proposed change in accounting. Sever reviewed and approved Bally's written preferability request before E&Y issued its final preferability letter.

44. Sever knew or should have known that Bally's change in accounting for reactivation revenues was not, in fact, a change in accounting principle, but rather was a correction of an error that required a restatement because Bally's original accrual methodology was not in conformity with GAAP. A change in accounting can only be used to move from a GAAP-compliant accounting methodology to a more preferable GAAP-compliant accounting methodology; errors in previously issued financial statements cannot be corrected through an

accounting change.[10] Bally's 2003 financial statements, therefore, improperly included a cumulative effect charge of $20.3 million associated with its change in accounting principle when its prior years' financial statements should have been restated. Accordingly, Bally's 2003 financial statements were not presented in conformity with GAAP, yet Sever did not object to E&Y issuing an unqualified audit opinion on Bally's 2003 financial statements in violation of GAAS.

Recognition Of Initiation Fee Revenue

45. For the year-end 2003 audit, E&Y and Sever turned their attention to Bally's other accounting estimates, including the member life estimates used in determining the amortization period of initiation fees that Sever knew or should have known were not in conformity with GAAP. Sever knew that E&Y had repeatedly identified as a "critical accounting policy" Bally's initiation fee revenue recognition methodology. Given the concerns about fraud perpetrated by means of accounting estimates, for the 2003 audit, E&Y planned to focus its attention on Bally's membership revenue recognition methodology.

46. E&Y's audit planning reflected its awareness that Bally had failed to update its member life estimate since 1997 and that the company had ignored both its commitment to the Commission staff to do so and E&Y's repeated recommendations to do so. Consistent with its audit planning concerns about Bally's aggressive estimates and the risk of financial fraud, E&Y requested that Bally provide support for the member life estimate for the 2003 fiscal year. Despite repeated efforts to obtain the information, E&Y never received the requested support.

47. Rather than continuing to press Bally for support for its complex accounting estimates, at a meeting on January 25, 2004, E&Y, including Sever, encouraged Bally to change its complex accounting methods, including initiation fee revenues. E&Y prepared an agenda for the January 2004 meeting with Bally; four of the five agenda items related to identified audit adjustments that subsequently totaled approximately $260 million.

48. At the January 2004 meeting, E&Y, including Sever, notified Bally that it would have to take a charge relating to new accounting guidance that Bally had failed to implement during the third quarter of 2003. E&Y also identified three adjustments that Bally would have to book. E&Y made clear that the new accounting guidance would require Bally to apply a modified cash basis of accounting to some of its contracts. As Bally and E&Y discussed the proposed change, Bally's CFO proposed adopting a modified cash basis of accounting for all of the company's membership contracts. Sever knew or should have known that the change to a modified cash basis for the rest of Bally's revenue recognition accounting would have the effect of allowing Bally to avoid or at least reduce the significance of some of the charges E&Y had identified. The proposed changes would also subsume some of the prior audit failures relating to initiation fee revenues. Bally changed its accounting and Sever reviewed and did not object to E&Y's issuance of a preferability letter that he knew or should have known enabled Bally to improperly avoid a restatement with respect to initiation fee revenue.

[10] *See* APB Opinion No. 20, *Accounting Changes.*

49. Bally's change from accrual accounting to a modified cash basis of accounting was not, in fact, a change in accounting principle, but rather involved a correction of an error that required a restatement because Bally's implementation of the deferral method for recognition of initiation fee revenue was not in conformity with GAAP. Accordingly, Bally's 2003 financial statements were not presented in conformity with GAAP, but Sever nonetheless reviewed and did not object to E&Y's issuance of an unqualified audit opinion on Bally's 2003 financial statements in violation of GAAS.

E&Y's Audit Was Deficient And Not Performed In Accordance With GAAS

50. E&Y's 2003 audit was deficient and not performed in accordance with GAAS. E&Y and Sever failed to obtain sufficient competent evidential matter to support an opinion that Bally's estimates, including the average member life estimates, were reasonable.[11] E&Y told Bally's audit committee that GAAS prescribed certain "mandatory procedures," including: "reviewing accounting estimates for biases that could result in material misstatement due to fraud, including retrospective review of significant prior year estimates. . . ."

51. E&Y and Sever also did not follow up on evidence that Bally's average member life estimates were biased and unsubstantiated.

52. The change in accounting to a modified cash basis resulted in Bally recording a cumulative effect adjustment ("CEA") of more than $441 million, which was much more than the effect of the identified audit adjustments referred to above, but allowed Bally to provide a positive explanation for the effect. Given that a significant amount of the CEA related to how Bally had amortized the initiation fees over a period of less than two years, Sever should have questioned how two supposedly GAAP-compliant methodologies resulted in such a material disparity in earnings. Nonetheless, he failed to do so. If he had followed up, Sever would have determined that Bally's prior calculation of the member life estimates was not reasonable and the Company's straight-line amortization of the financed membership initiation fees over a 22-month period was not in conformity with GAAP.

53. Just as E&Y's issuance of a preferability letter with regard to the change in accounting for reactivation dues was improper, so too was its issuance of a preferability letter with regard to the change to a modified cash basis for initiation fees. By the time E&Y began the 2003 audit, Sever knew or should have known of the issues associated with the average member life estimate that required vigorous audit procedures, yet he failed to respond adequately.

54. Sever knew or should have known that Bally's 2003 financial statements were not presented in conformity with GAAP, and he failed to require E&Y to qualify its opinion or issue an adverse opinion as required by GAAS.

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[11] *See* AU § 230, *Due Professional Care*; AU § 326, *Evidential Matter* ("AU § 326"); AU § 333A, *Management Representations*.

Sever Knew Or Should Have Known Bally Made Improper Disclosures Concerning The Lack Of Disagreements And Reportable Events With E&Y

55. When an auditor to a public company resigns, Item 304 of Regulation S-K requires both the company and the auditor to disclose whether any "disagreements" or "reportable events" occurred in the two most recent fiscal years or any subsequent interim period. The term "disagreements" is interpreted broadly, to include any difference of opinion concerning any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures which (if not resolved to the former auditor's satisfaction) would have caused it to make reference to the issue in its audit opinion. The term "reportable events" includes events such as the auditor having advised the company that it questions the reliability of (1) the company's financial statements, (2) management's representations, or (3) the company's internal controls. Item 304 also requires the former auditor to file a letter stating whether it agrees with the company's Item 304 disclosures and, if not, stating the areas of disagreement.

56. In March 2004, Sever, and other senior E&Y partners, including the Engagement Partner and the IRP, participated in a meeting during which they decided to resign as Bally's auditor. A memorandum prepared by the Engagement Partner for the meeting, and given to Sever and others to review and comment prior to the meeting, identified reasons for resigning, including the engagement team's distrust of Bally's senior financial management; its concerns regarding the company's internal controls and accuracy of accounting records and the accuracy of management's accounting estimates. In addition, Sever knew of contentious discussions with Bally's management over various issues, including E&Y's demand that Bally end its practice of recognizing revenue from reactivations that Bally projected would occur in the future.

57. Following the internal E&Y meeting, E&Y advised Bally's Audit Committee that it would resign from the engagement because of concerns regarding management's tone, the company's need to demonstrate more concern regarding internal control issues and the accuracy of its accounting records, and the accuracy of management's estimates.

58. In Bally's 2003 Form 10-K disclosure, the Company announced E&Y's resignation but represented that there were no disagreements or reportable events. Similarly, E&Y filed a letter with the Commission stating that it agreed with Bally's statements there had been no disagreements or reportable events with Bally's management.

59. The events described above reflect "disagreements" and "reportable events" that were required to be disclosed under Item 304 of Regulation S-K. Sever knew or should have known that these disagreements and reportable events were required to be disclosed, but did not object to the representations in Bally's 2003 Form 10-K stating there had been no "disagreements" or "reportable events;" or prevent E&Y from issuing a letter agreeing with the Company's Item 304 disclosures.

Violations

60. Section 17(a)(2) of the Securities Act prohibits obtaining money or property by means of untrue statements of material fact or misleading omissions of material fact in the offer or sale of securities. Section 17(a)(3) of the Securities Act prohibits engaging in transactions, practices or courses of business which operate or would operate as a fraud or deceit upon the purchaser in the offer or sale of securities. Information is material where there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Establishing violations of Section 17(a)(2) and 17(a)(3) does not require a showing of scienter. *Aaron v. SEC*, 446 U.S. 680, 697 (1980).

61. Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11 and 13a-13 thereunder require all issuers with securities registered under Section 12 of the Exchange Act to file annual, current and quarterly reports on Form 10-K, Form 8-K and Form10-Q, respectively. Exchange Act Rule 12b-20 further requires that, in addition to the information expressly required to be included in such reports, the issuer must include such additional material information as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading. The obligation to file these periodic reports includes the obligation that they be complete and accurate in all material respects. *See, e.g., SEC v. IMC Int'l, Inc.*, 384 F. Supp. 889, 893 (N.D. Tex.), *aff'd mem.*, 505 F.2d 733 (5th Cir. 1974). No showing of scienter is necessary to establish a violation of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13 and 12b-20. *See SEC v. McNulty*, 137 F.3d 732, 740-741 (2d Cir. 1998).

62. Section 13(b)(2)(A) of the Exchange Act requires issuers to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."

63. Bally violated Section 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder by, among other things, prematurely recognizing income and improperly deferring costs which resulted in its books and records being false, failing to maintain accurate books and records, and including misleading financial statements and information in annual, quarterly and current reports filed with the Commission in connection with fiscal years 2001 through 2003.

64. Sever was a cause of and aided and abetted Bally's violations. For each of the years 2001-2003, Sever reviewed and did not object to E&Y's issuance of audit reports containing unqualified opinions stating that E&Y had conducted an audit of the company's annual financial statements in accordance with GAAS and that Bally's financial statements were presented in conformity with GAAP. These audit reports were included in Bally's Forms 10-K for 2001-2003. However, Sever knew or should have known that E&Y's audit reports were false and misleading because E&Y failed to conduct its audits in accordance with GAAS and Bally was engaged in accounting practices and disclosures that were not in conformity with GAAP.

65. In auditing Bally's accounting practices relating to reactivation revenue, initiation fee revenue and deferred acquisition costs, Sever failed under GAAS to exercise due professional care and skepticism, failed to ensure that E&Y obtained sufficient competent evidential matter, and substituted managements' representations for competent evidence supporting the accounting. Sever failed to insist that Bally provide support for certain of these estimates, nor did Sever require that the engagement team perform sufficient audit procedures to test and determine whether these accounting actions resulted in appropriate recognition of revenue. Had he done so, he would have reasonably determined that these accounting practices were not in conformity with GAAP.

66. Despite these accounting and audit failures, and in further violation of GAAS, Sever did not require E&Y to express a qualified or adverse audit opinion, or refuse by disclaimer to express any opinion at all, but instead issued audit reports that contained unqualified opinions on Bally's 2001-2003 financial statements. Sever also knew or should have known that Bally was making false and misleading disclosures such as in connection with its $55 million special charge. Nor did Sever propose that Bally correct its improper accounting in the quarterly financial statements that E&Y reviewed during 2001-2003. Sever also did not object to E&Y improperly issuing preferability letters that allowed Bally to switch its accounting policies for reactivation revenue and initiation fee revenue instead of restating for errors relating to that accounting. Accordingly, Sever's failure to comply with GAAS was a cause of Bally's violations of Section 17(a)(2) and (3) of the Securities Act and was a cause of and aided and abetted Bally's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder.

67. Sever also was a cause of E&Y's violation of Section 10A(b) of the Exchange Act in connection with Bally's failure to disclose that the $55 million special charge recorded in its FY 2002 financial statements was due to a deterioration in the collectability of the Company's receivables. Sever failed to require E&Y to report this illegal act to the Audit Committee in accordance with Section 10A(b).

Findings

As a result of the conduct described above, Sever was a cause of Bally's violations of Sections 17(a)(2) and (3) of the Securities Act and was a cause of and willfully aided and abetted Bally's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. Sever also was a cause of E&Y's violation of Section 10A(b) of the Exchange Act by not ensuring that E&Y brought to the attention of Bally's Audit Committee Bally's false and misleading disclosures of the $55 million special charge.

IV.

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

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

A. Sever cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act, and from causing any violations and any future violations of Sections 10A(b), 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder;

B. Sever is denied the privilege of appearing or practicing before the Commission as an accountant pursuant to Rule 102(e)(1)(iii);

C. After 3 years from the date of this order, Sever 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 Sever'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) Sever, 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) Sever, 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 Sever's or the firm's quality control system that would indicate that Sever will not receive appropriate supervision;

(c) Sever 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) Sever acknowledges his responsibility, as long as Sever 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 Sever 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 Sever's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9095 / December 17, 2009

SECURITIES EXCHANGE ACT OF 1934
Release No. 61194 / December 17, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3085 / December 17, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13723

In the Matter of **JOHN M. KISS, CPA,** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), and Rule 102(e)(1)(iii) of the Commission's Rules of Practice[2] against John M. Kiss ("Kiss" or "Respondent").

[1] Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

[2] Rule 102(e)(1) provides, in pertinent part, that:

> The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found...

II.

In anticipation of the institution of these proceedings, Kiss 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, Kiss consents to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 4C and 21C of the Securities Exchange Act of 1934, and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Kiss' Offer, the Commission finds[3] that:

Summary

1. This matter involves violations of the federal securities laws by Kiss in connection with the 2001 and 2002 audits of Bally Total Fitness Holding Corporation ("Bally") conducted by Ernst & Young LLP ("E&Y") while Kiss served as the engagement partner on those audits. Kiss was the engagement partner on E&Y's audits of Bally from 1996 through and including 2002.

2. In connection with Bally's 2001-2002 financial statements, Bally engaged in fraudulent financial accounting, including prematurely recognizing revenue and improperly deferring costs, which overstated income and inflated stockholders' equity. Bally also made false and misleading disclosures regarding a $55 million special charge in its 2002 Form 10-K. On November 30, 2005, Bally filed its 2004 Form 10-K, which restated its previously reported financial statements for 2002 and 2003, and selected financial data for 2000 and 2001.

3. Kiss knew or should have known that E&Y's unqualified audit opinions regarding Bally's 2001-2002 financial statements -- which stated that E&Y had conducted its audits in accordance with auditing standards generally accepted in the United States ("GAAS") and that Bally's financial statements were presented in conformity with accounting principles generally accepted in the United States ("GAAP") -- were false because E&Y's audits of Bally's financial

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(iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

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

statements were not performed in accordance with GAAS and Bally's financial statements were not presented in conformity with GAAP.

4. As a result of the false and misleading audit opinions, Kiss was a cause of Bally's violations of Sections 17(a)(2) and (3) of the Securities Act, and was a cause of and willfully[4] aided and abetted Bally's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13. Kiss also was a cause of E&Y's violation of Section 10A(b) of the Exchange Act by not bringing to the attention of Bally's Audit Committee Bally's false and misleading disclosures of the $55 million special charge.

Respondent

5. Kiss is, and was at all relevant times, a Certified Public Accountant licensed in Illinois. He worked in the Chicago office of E&Y during the relevant period and was the engagement partner in charge of E&Y's audits of Bally from 1996 through and including 2002. Kiss retired from E&Y in January 2008.

Issuer

6. Bally Total Fitness Holding Corporation, a Delaware corporation, purported to be the largest, and only nationwide, commercial operator of fitness centers. At all relevant times, Bally's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange ("NYSE"). The NYSE delisted Bally's common stock on June 8, 2007. After filing for reorganization under Chapter 11 of the Bankruptcy Code, on September 17, 2007, Bally emerged as a privately held reorganized entity. On February 28, 2008, the Commission filed a settled injunctive action against Bally in the United States District Court for the District of Columbia, charging Bally with violating Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. The District Court issued permanent injunctions on May 8, 2008.

Background

7. For many years up until it resigned in 2004, E&Y audited Bally's financial statements. Bally's principal source of revenue was selling gym membership contracts, which provided customers access to gyms in exchange for the payment of both a one-time initiation fee and monthly dues. The one-time fee was typically several thousand dollars, while the monthly dues typically were less than $10 per month. Most of Bally's customers financed their initiation fees. To maintain their memberships, customers were required to pay their initiation fee in full and pay monthly dues. The initiation fees were Bally's biggest source of revenue. The obligation to pay the initiation fee was legally enforceable; there was no legal obligation to pay monthly dues beyond the initial contract period.

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[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)).

8. E&Y recognized Bally as a risky audit and, from at least 1996 through 2003, designated Bally as a "close monitoring" account because Bally presented a risk that created "a significant chance the firm [E&Y] will suffer damage to its reputation, monetarily, or both." Bally was designated a close monitoring account for several reasons, including, among other things, that Bally's managers were former E&Y audit partners who were "difficult" and had "historically been aggressive in selecting accounting principles and determining estimates;" the managers placed undue emphasis on maintaining stock prices; management used "(un)reliable . . . estimation process[es] or questionable judgments;" and Bally's compensation plans placed undue emphasis on reported earnings. E&Y's internal guidance notes that a "history of 'aggressive' applications of accounting policies could indicate a predisposition to misstate the financial statements."

9. In early 2002, E&Y sought to reduce its risk by identifying its riskiest clients and resigning from them or otherwise managing the risk they presented to E&Y. Out of a total of over 10,000 audit clients in North America, E&Y identified Bally as one of the riskiest 18 accounts. These 18 accounts were so-called "National Focus Accounts" and were monitored by the Americas Executive Board. Not only was Bally identified as a National Focus Account, it was identified as the riskiest account in E&Y's Lake Michigan Area.

Bally's Accounting Errors And E&Y's Audit Failures Relating To Fiscal Years 2001 And 2002

10. In connection with fiscal years 2001 and 2002, as well as earlier years, Bally engaged in certain accounting practices relating to its recognition of reactivation revenue, initiation fee revenue, and deferred costs that made its financial statements false and misleading. E&Y issued unqualified audit opinions, in violation of GAAS, in connection with its audits of such financial statements.

Premature Recognition Of Reactivation Revenues

11. Bally recognized revenue from what it called "reactivations," which were payments from Bally members who had completed their initial contract period, but whose memberships were canceled for failure to pay the monthly dues necessary to maintain their membership. Bally did not attempt to recover those dues because there was no legal obligation to pay dues. Accordingly, for those canceled members who had completed the initial contract period, Bally waited at least six months after receiving their last payment and then began soliciting these canceled members to reactivate. Those who accepted the reactivation offers did so, on average, 36 months after having stopped paying monthly dues. The reactivation offers did not contain claims for or seek payment of "past due" amounts. Instead, they asked for either a nominal reactivation fee or no reactivation fee at all, and the payment of monthly dues for a period of future service.

12. Bally's reactivation revenue recognition policy was to project (as of the balance sheet date) the reactivation payments it anticipated receiving in the coming year and then immediately recognize most of these projected payments by improperly allocating them to past

periods. Bally's reactivation revenue recognition policy was not in conformity with GAAP because use of the method enabled Bally to recognize revenue before it was earned and was realized or realizable.[5] Bally recognized revenue before it was earned because, among other things, it barred canceled former members from the gyms, and therefore, had not provided services to those of its canceled members who might reactivate in the future. Additionally, Bally recognized revenue before it was realized or realizable because it was recognizing revenue for reactivations that had not yet occurred, which it anticipated from canceled former members whom it could not identify individually and who had no legal obligation to reactivate or pay Bally anything at all.

13. In short, Bally violated GAAP by recognizing revenue related to the anticipated future payments before the reactivation transactions occurred. The accounting was clearly not in conformity with GAAP, and a reasonable accountant who understood Bally's accrual basis of recognizing revenue for "reactivations" would conclude that it was not in conformity with GAAP, because Bally was recognizing revenue that was not realized or realizable, and had not been earned.

14. For at least six years, E&Y had audited Bally's "reactivation" revenue recognition practices. In each of those years, E&Y provided Bally with an unqualified audit opinion.

15. Kiss knew or should have known that Bally's accounting policy for reactivation revenues was not in conformity with GAAP, yet he caused E&Y to issue unqualified opinions regarding Bally's 2001 and 2002 financial statements in violation of GAAS.[6]

Premature Recognition Of Initiation Fee Revenue

16. Members paid a substantial initiation fee in connection with new membership contracts. Beginning in 1997, Bally recognized initiation fee revenue over the estimated average membership life, which included an estimate for both the average initial contract period and the average renewal period. Bally computed the weighted average expected membership life to be 22 months for financed memberships and 36 months for cash memberships.

17. Bally's 1997 computations of the weighted average expected membership life were flawed. A cursory inspection of the computations would have revealed these flaws. In 1997, E&Y had checked Bally's arithmetic and suggested some minor adjustments, but had failed to test whether Bally's computations produced results that were consistent with reality, and failed to determine that Bally's computation was fundamentally incorrect. The errors in Bally's estimates had the effect of understating the average membership life. As a result, Bally's

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[5] *See, e.g.*, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* ("ARB 43"), Chapter 1A (1953); Accounting Principles Board Opinion No. 10, Omnibus Opinion (1966); Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (1985); Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, Topic 13.A. (1999)("SAB 101").

[6] *See* AICPA's Codification of Auditing Standards AU § 508, *Reports on Audited Financial Statements*, ("AU § 508").

member life estimates improperly accelerated revenue recognition and distorted the economic reality of Bally's business.

18. These errors continued through the relevant period. Kiss knew or should have known that by recognizing initiation fee revenue from financed contracts over 22 months, Bally was improperly recognizing revenue before it was earned and realized or realizable in contravention of GAAP, yet he caused E&Y to issue unqualified opinions regarding Bally's 2001 and 2002 financial statements in violation of GAAS.

<u>Deferral Of Member Acquisition Costs</u>

19. Bally deferred certain of its costs associated with acquiring new members and recognized such costs over the same period that it deferred initiation fee revenue.

20. GAAP requires that any costs deferred must be direct and incremental to the acquisition of a new contract or activities directly related to such acquisitions (i.e., they would not have been incurred "but for" the acquisition of the contract). Costs associated with acquiring new members are properly deferrable to the extent that they were direct and incremental to the acquisition of a new member contract, while all other costs must be expensed as incurred.[7] Bally, however, improperly deferred certain costs that were not eligible for deferral.

21. Kiss knew or should have known that Bally was improperly deferring certain member acquisition costs; nonetheless, he caused E&Y to issue unqualified opinions regarding Bally's 2001 and 2002 financial statements in violation of GAAS.

<u>E&Y's Audits Were Deficient And Not Performed In Accordance With GAAS</u>

22. E&Y's audits of Bally's reactivation revenues, initiation fee revenues and deferred acquisition costs were deficient and not performed in accordance with GAAS. As an initial matter, Kiss knew that Bally was a risky client due to, among other things, management's aggressive accounting policies. On the client continuance forms, Kiss repeatedly identified aggressive accounting by Bally's management as one of the principal reasons for Bally's riskiness. In 1997, he wrote: "Management has a history of being aggressive from an accounting standpoint." As part of the client continuance process in 1998, he wrote that he wanted to discuss with E&Y management, inter alia, Bally's "aggressive [management]."

23. In response to a request for an "[e]xplanation of risk factors," Kiss wrote in 1999, "There are a number of former EY employees at the Company. The CEO and CFO have historically taken some aggressive accounting positions." In 2000, Kiss' "explanation of risk factors" provided, in relevant part: "Management is very focused on meeting or beating the

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[7] *See* Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* (Dec. 1986); FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts,* (Dec. 1990); and SAB 101, Topic 13.A.

Street's EPS. This at times leads to aggressive accounting practices." In 2001, Kiss explained, "management tends to be aggressive in their accounting."

24. From at least 1996, E&Y annually identified Bally as a "close-monitoring" account. Each year, E&Y's partners and management assessed the level of risk presented by each of its audit clients, including Bally, as part of E&Y's "client continuance process." Higher risk accounts were denominated "close-monitoring accounts."

25. E&Y prepared, and Kiss read and concurred in, a memorandum in connection with the FY 2000 audit, which concluded, improperly, that Bally's reactivation revenue accrual "does not appear to be precluded by SAB 101." The memorandum indicated that (a) members who did not pay dues after the initial contract period were barred from the gyms after a grace period, and (b) these members had no legally enforceable obligation to pay dues after the initial contract period or to reactivate their memberships. Kiss knew or should have known that these facts undermined and contradicted the conclusion that the reactivation accrual "does not appear to be precluded by SAB 101." In concluding that Bally's reactivation revenue policy was in conformity with GAAP, Kiss failed to reasonably assess whether Bally's financial statements were presented in conformity with GAAP, as required by GAAS.

26. Initiation fee revenue was the largest component of Bally's revenue. In 1997, Bally had committed to the Commission staff that the company would periodically update its member life estimates. Contrary to that commitment, Bally failed to update its member life estimates throughout the period that Kiss remained as engagement partner.

27. Kiss knew of Bally's failure to keep that commitment. In letters to Bally's management, E&Y formally requested Bally to update its member life computations in 1998, 2001, and 2002, but Bally never did so. In response to the 2001 request, Bally asserted that the 1997 calculations were still "an appropriate approximation of the current historical average membership length" because the original calculation constituted a "35-year historical average." In fact, the 1997 calculation did not constitute a 35-year historical average, but reflected an average from a much smaller pool of data. Kiss knew or should have known that Bally's representations regarding the 1997 calculation were false and should not have been relied on as persuasive evidence supporting its opinion.[8]

28. E&Y and Kiss failed to perform adequate audit procedures with regard to the renewal period estimate and the resulting amortization period.[9] Rather, E&Y simply carried forward the 1997 estimates pertaining to the average renewal period. Given the critical nature of this accounting estimate, Kiss' failure to obtain from the Company an update or to arrive at its own independent estimate constitutes a departure from GAAS.

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[8] *See* AU § 230, *Due Professional Care*; AU § 326, *Evidential Matter* ("AU § 326"); AU § 333A, *Management Representations.*

[9] *See* AU § 342, *Auditing Accounting Estimates.*

29. Kiss also knew or should have known of Bally's arbitrary and unsupported allocation of various costs to the deferred member acquisition cost pool, but failed to perform adequate audit procedures with regard to those deferred member acquisition costs.

30. Kiss knew or should have known that Bally's 2001 and 2002 financial statements were not presented in conformity with GAAP, but he failed to qualify the audit opinion or issue an adverse opinion as required by GAAS.

E&Y Seeks To Reduce Its Risk

31. In 2001 and 2002, a series of widely-known financial scandals led E&Y to assess its audit risks and the firm took steps to identify and resign from or focus on certain of its riskiest clients. Internally, E&Y was communicating the dangers of retaining high risk clients, but even though E&Y identified Bally as one of its riskiest clients during the 2002 client continuance process, E&Y did not resign from Bally. Instead, E&Y tried to reduce the risk that Bally's accounting practices posed to E&Y by, among other things, insisting for the first time that Bally record the numerous accounting errors that had "historically been [placed by E&Y] on the summary of audit differences."

32. From July 2002 through March 2003, E&Y, including Kiss, had numerous internal communications and meetings regarding the risks posed by Bally generally, as well as particular risky accounting issues, including, among other things, Bally's revenue recognition estimates. Bally was the subject of a series of meetings with E&Y management, and Bally was placed on a list of National Focus Accounts for Americas Executive Board attention.

Bally's False And Misleading Disclosures
Regarding A $55 Million Charge In Fiscal Year 2002

33. As of 2002, Bally's allowance for doubtful accounts ("ADA") had long been on E&Y's list of concerns regarding aggressive accounting. Bally's estimate of the ADA was another area in which Bally's management's estimates appeared aggressive. Year in and year out, from 1997 through 2002, Bally consistently used a 41% reserve rate, despite changes in the economy and in market conditions. The resulting ADA was always at the low end of the range that E&Y had deemed to be reasonable.

34. During the third quarter of 2002, Kiss and others at E&Y determined that Bally's collections had deteriorated substantially, and they advised Bally that it needed to increase its ADA in order to cover the shortfall resulting from the deteriorating collections. Bally insisted that no change be made to the ADA until the fourth quarter to allow it time to obtain waivers of debt covenants provisions from Bally's lenders.

35. During the fourth quarter of 2002, Bally agreed to increase its ADA by $55 million and ultimately presented it as a "special charge" in Bally's year-end financial statements. In its 2002 Form 10-K, including in the notes to the financial statements, Bally made false and misleading disclosures regarding the reasons for the charge, and Kiss knew or should have known that the disclosures were improper. The reason for the charge cited in the

Form 10-K was that Bally's estimation was based on an accelerated monetization scenario which would result in collecting less than book value. No mention was made of the deterioration of the collectability of Bally's accounts receivable portfolio, which had been identified by E&Y as requiring Bally to take a charge.

36. The $55 million special charge virtually eliminated Bally's 2002 earnings. Kiss knew or should have known that Bally's disclosures failed to disclose accurately the reasons for the "special charge," yet he did not object and he caused E&Y to issue an unqualified audit opinion upon Bally's 2002 financial statements in violation of GAAS.[10] Kiss also failed to cause E&Y to inform Bally's Audit Committee about Bally's false and misleading disclosures, and no such information was provided to Bally's Audit Committee.

Violations

37. Section 17(a)(2) of the Securities Act prohibits obtaining money or property by means of untrue statements of material fact or misleading omissions of material fact in the offer or sale of securities. Section 17(a)(3) of the Securities Act prohibits engaging in transactions, practices or courses of business which operate or would operate as a fraud or deceit upon the purchaser in the offer or sale of securities. Information is material where there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Establishing violations of Section 17(a)(2) and 17(a)(3) does not require a showing of scienter. *Aaron v. SEC*, 446 U.S. 680, 697 (1980).

38. Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11 and 13a-13 thereunder require all issuers with securities registered under Section 12 of the Exchange Act to file annual, quarterly and current reports on Form 10-K, Form 8-K and Form10-Q respectively. Exchange Act Rule 12b-20 further requires that, in addition to the information expressly required to be included in such reports, the issuer must include such additional material information as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading. The obligation to file these periodic reports includes the obligation that they be complete and accurate in all material respects. *See, e.g., SEC v. IMC Int'l, Inc.*, 384 F. Supp. 889, 893 (N.D. Tex.), *aff'd mem.*, 505 F.2d 733 (5th Cir. 1974). No showing of scienter is necessary to establish a violation of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13 and 12b-20. *See SEC v. McNulty*, 137 F.3d 732, 740-741 (2d Cir. 1998).

39. Section 13(b)(2)(A) of the Exchange Act requires issuers to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."

40. Bally violated Sections 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder by, among other things, prematurely recognizing income and improperly deferring costs which

[10] *See* AU § 431, *Adequacy of Disclosure in Financial Statements*; AU § 508.

resulted in its books and records being false, failing to maintain accurate books and records and including material false and misleading financial statements and information in annual, quarterly and current reports filed with the Commission in connection with fiscal years 2001 and 2002.

41. Kiss was a cause of and/or aided and abetted Bally's violations. For each of the years 2001-2002, Kiss was a cause of E&Y issuing audit reports containing unqualified opinions stating that E&Y had conducted an audit of the company's annual financial statements in accordance with GAAS and that Bally's financial statements were presented in conformity with GAAP. These audit reports were included in Bally's Forms 10-K for 2001-2002. However, Kiss knew or should have known that E&Y's audit reports were false and misleading because E&Y failed to conduct its audits in accordance with GAAS and Bally was engaged in accounting practices and disclosures that were not in conformity with GAAP.

42. In auditing Bally's accounting practices relating to reactivation revenue, initiation fee revenue and deferred acquisition costs, Kiss failed under GAAS to exercise due professional care and skepticism, failed to obtain sufficient competent evidential matter, and substituted managements' representations for competent evidence supporting the accounting. Kiss never insisted that Bally provide support for certain of these estimates, nor did Kiss perform sufficient audit procedures to test and determine whether these accounting actions resulted in appropriate revenue. Had he done so, he would have reasonably determined that these accounting practices were not in conformity with GAAP.

43. Kiss also knew or should have known that Bally was making false and misleading disclosures in connection with its $55 million special charge. Kiss did not propose that Bally correct its improper accounting in the quarterly financial statements that E&Y reviewed during 2001-2002. Accordingly, Kiss was a cause of Bally's violations of Sections 17(a)(2) and (3) of the Securities Act and was a cause of and aided and abetted Bally's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder.

44. Kiss also was a cause of E&Y's violation of Section 10A(b) of the Exchange Act in connection with Bally's failure to disclose that the $55 million special charge recorded in its FY 2002 financial statements was due to a deterioration in the collectability of the Company's receivables and E&Y's failure to report this illegal act to the Audit Committee.

Findings

As a result of the conduct described above, Kiss was a cause of Bally's violations of Sections 17(a)(2) and (3) of the Securities Act and was a cause of and willfully aided and abetted Bally's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. Kiss also was a cause of E&Y's violation of Section 10A(b) of the Exchange Act by not ensuring that E&Y brought to the attention of Bally's Audit Committee Bally's false and misleading disclosures of the $55 million special charge.

IV.

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

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

A. Kiss cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act, and from causing any violations and any future violations of Sections 10A(b), 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder;

B. Kiss is denied the privilege of appearing or practicing before the Commission as an accountant pursuant to Rule 102(e)(1)(iii);

C. After 3 years from the date of this order, Kiss 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 Kiss' 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) Kiss, 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) Kiss, 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 Kiss' or the firm's quality control system that would indicate that Kiss will not receive appropriate supervision;

(c) Kiss 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) Kiss acknowledges his responsibility, as long as Kiss 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 Kiss 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 Kiss' character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9096 / December 17, 2009

SECURITIES EXCHANGE ACT OF 1934
Release No. 61196 / December 17, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3087 / December 17, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13725

In the Matter of

ERNST & YOUNG LLP

Respondent.

ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), and Rule 102(e)(1)(iii) of the Commission's Rules of Practice against Ernst & Young LLP ("Respondent").[2]

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[1] Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

[2] Rule 102(e)(1) provides, in pertinent part, that:

> The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found…

(iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 4C and 21C of the Securities Exchange Act of 1934, and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[3] that:

Summary

1. This matter involves violations of the federal securities laws by Ernst & Young LLP ("E&Y") while serving as public auditor for Bally Total Fitness Holding Corporation ("Bally") from 2001 through 2004. In connection with Bally's 2001-2003 financial statements, Bally engaged in fraudulent financial accounting, including prematurely recognizing revenue and improperly deferring costs, which overstated income and inflated stockholders' equity. Bally also made false and misleading disclosures regarding a $55 million special charge in its 2002 Form 10-K. On November 30, 2005, Bally filed its 2004 Form 10-K, which restated its previously reported financial statements for 2002 and 2003, and selected financial data for 2000 and 2001.

2. Notwithstanding that it knew or should have known of Bally's fraudulent financial accounting and false and misleading disclosures, E&Y issued unqualified audit opinions regarding Bally's 2001-2003 financial statements, which stated that E&Y had conducted its audits in accordance with auditing standards generally accepted in the United States ("GAAS") and that Bally's financial statements were presented in conformity with accounting principles generally accepted in the United States ("GAAP"). Contrary to the audit opinions, E&Y's audits of Bally's financial statements were not performed in accordance with GAAS and Bally's financial statements were not in conformity with GAAP.

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

3. By issuing these false and misleading audit opinions, E&Y was a cause of and aided and abetted Bally's violations of Sections 17(a)(2) and (3) of the Securities Act and Sections 13(a) and (b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13. E&Y also violated Section 10A of the Exchange Act by not bringing to the attention of Bally's Audit Committee Bally's false and misleading disclosures of the $55 million special charge.

Respondent

4. Ernst & Young LLP was Bally's independent auditor throughout the relevant period. On March 30, 2004, Bally announced that E&Y had resigned as its independent auditor.

Issuer

5. Bally Total Fitness Holding Corporation, a Delaware corporation, purported to be the largest, and only nationwide, commercial operator of fitness centers. At all relevant times, Bally's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange ("NYSE"). The NYSE delisted Bally's common stock on June 8, 2007. After filing for reorganization under Chapter 11 of the Bankruptcy Code, on September 17, 2007, Bally emerged as a privately held reorganized entity. On February 28, 2008, the Commission filed a settled injunctive action against Bally in the United States District Court for the District of Columbia, charging Bally with violating Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. The District Court issued permanent injunctions on May 8, 2008.

Background

6. For many years up until it resigned in 2004, E&Y audited Bally's financial statements. Bally's principal source of revenue was selling gym membership contracts, which provided customers access to gyms in exchange for the payment of both a one-time initiation fee and monthly dues. The one-time fee was typically several thousand dollars, while the monthly dues typically were less than $10 per month. Most of Bally's customers financed their initiation fees. To maintain their memberships, customers were required to pay their initiation fee in full and pay monthly dues. The initiation fees were Bally's biggest source of revenue. The obligation to pay the initiation fee was legally enforceable; there was no legal obligation to pay monthly dues beyond the initial contract period.

7. E&Y recognized Bally as a risky audit and, from at least 1996 through 2003, designated Bally as a "close monitoring" account because Bally presented a risk that created "a significant chance the firm [E&Y] will suffer damage to its reputation, monetarily, or both." Bally was designated a close monitoring account for several reasons, including, among other things, that Bally's managers were former E&Y audit partners who were "difficult" and had "historically been aggressive in selecting accounting principles and determining estimates;" the managers placed undue emphasis on maintaining stock prices; management used "(un)reliable

. . . estimation process[es] or questionable judgments;" and Bally's compensation plans placed undue emphasis on reported earnings. E&Y's internal guidance notes that a "history of 'aggressive' applications of accounting policies could indicate a predisposition to misstate the financial statements."

8. In early 2002, E&Y sought to reduce its risk by identifying its riskiest clients and resigning from them or otherwise managing the risk they presented to E&Y. Out of a total of over 10,000 audit clients in North America, E&Y identified Bally as one of the riskiest 18 accounts. These 18 accounts were so-called "National Focus Accounts" and were monitored by the Americas Executive Board. Not only was Bally identified as a National Focus Account, it was identified as the riskiest account in E&Y's Lake Michigan Area.

Bally's Accounting Errors and E&Y's Audit Failures Relating to Fiscal Years 2001 and 2002

9. In connection with fiscal years 2001 and 2002, as well as earlier years, Bally engaged in certain practices relating to its recognition of reactivation revenue, initiation fee revenue, and deferred costs that made its financial statements false and misleading. E&Y, which knew or should have known of these practices, issued unqualified audit opinions in connection with its audits of such financial statements.

Premature Recognition of Reactivation Revenues

10. Bally recognized revenue from what it called "reactivations," which were payments from Bally members who had completed their initial contract period, but whose memberships were canceled for failure to pay the monthly dues necessary to maintain their membership. Bally did not attempt to recover those dues because there was no legal obligation to pay dues. Accordingly, for those canceled members who had completed the initial contract period, Bally waited at least six months after receiving their last payment and then began soliciting these canceled members to reactivate. Those who accepted the reactivation offers did so, on average, 36 months after having stopped paying monthly dues. The reactivation offers did not contain claims for or seek payment of "past due" amounts. Instead, they asked for either a nominal reactivation fee or no reactivation fee at all, and the payment of monthly dues for a period of future service.

11. Bally's reactivation accounting policy was to project (as of the balance sheet date) the reactivation payments it anticipated receiving in the coming year and then immediately recognize most of these projected payments by improperly allocating them to past periods. Bally's reactivation accounting was not in conformity with GAAP because Bally recognized revenue before it was earned and was realized or realizable. Bally recognized revenue before it was earned because, among other things, it barred canceled former members from the gyms, and therefore, had not provided services to those of its canceled members who might reactivate in the future. Additionally, Bally recognized revenue before it was realized or realizable because it was recognizing revenue for reactivations that had not yet occurred, which it anticipated from canceled former members whom it could not identify individually and who had no legal obligation to reactivate or pay Bally anything at all. In short, Bally violated GAAP by

recognizing revenue related to the anticipated future payments before the reactivation transactions occurred.

12. E&Y knew or should have known that Bally's accounting policy for reactivation revenues was not in conformity with GAAP, yet it issued unqualified opinions regarding Bally's 2001 and 2002 financial statements.

Premature Recognition of Initiation Fee Revenue

13. Members paid a substantial initiation fee in connection with new membership contracts. Beginning in 1997, Bally recognized initiation fee revenue over the estimated average membership life, which included an estimate for both the average initial contract period and the average renewal period. Bally computed the weighted average expected membership life to be 22 months for financed memberships and 36 months for cash memberships.

14. Bally's 1997 computations of the weighted average expected membership life were flawed. A cursory inspection of the computations would have revealed these flaws. In 1997, E&Y had checked Bally's arithmetic and suggested some minor adjustments, but had failed to test whether Bally's computations produced results that were consistent with reality, and failed to determine that Bally's computation was fundamentally incorrect. The errors in Bally's estimates had the effect of understating the average membership life. As a result, Bally's member life estimates improperly accelerated revenue recognition and distorted the economic reality of Bally's business.

15. These errors continued through the relevant period and E&Y knew or should have known that by recognizing initiation fee revenue from financed contracts over 22 months, Bally was improperly recognizing revenue before it was earned and realized or realizable in contravention of GAAP.

E&Y's Audits Were Deficient and Not Performed in Accordance with GAAS

16. E&Y's audits of Bally's reactivation accounting and initiation fee revenues were deficient and not performed in accordance with GAAS. As an initial matter, E&Y knew that Bally was a risky client due to, among other things, management's aggressive accounting policies.

17. E&Y prepared a memorandum in connection with the FY 2000 audit, which concluded, improperly, that Bally's reactivation revenue accrual "does not appear to be precluded by SAB 101." The memorandum indicated that (a) members who did not pay dues after the initial contract period were barred from the gyms after a grace period, and (b) these members had no legally enforceable obligation to pay dues after the initial contract period or to reactivate their memberships. E&Y knew or should have known that these facts undermined and contradicted the conclusion that the reactivation accrual "does not appear to be precluded by SAB 101." E&Y should not have concluded that Bally's reactivation revenue policy was in conformity with GAAP and thus E&Y failed to reasonably assess whether Bally's financial statements were presented in conformity with GAAP, as required by GAAS.

18. E&Y also knew or should have known that part of the rationale contained in the 2000 memo supporting Bally's reactivation revenue policy -- that reactivation revenue was a continuation of the original contract -- was contrary to a representation that Bally had previously made to the Commission staff, in connection with its calculation of the average membership life estimate, that reactivation memberships were "in substance and in form, new contractual arrangements." E&Y failed to address or resolve Bally's conflicting revenue-recognition treatments of reactivation memberships.

19. Initiation fee revenue was the largest component of Bally's revenue. In 1997, Bally had committed to the Commission staff that the company would periodically update its member life estimates. Contrary to that commitment, Bally failed to update its member life estimates throughout the period E&Y remained its auditor.

20. E&Y knew of Bally's failure to keep that commitment. In fact, E&Y formally requested Bally to update its member life computations in 1998, 2001, and 2002, but Bally never did so. In response to E&Y's 2001 request, Bally asserted that the 1997 calculations were still "an appropriate approximation of the current historical average membership length" because the original calculation constituted a "35-year historical average." In fact, the 1997 calculation did not constitute a 35-year historical average, but reflected an average from a much smaller pool of data. E&Y knew or should have known that Bally's representations regarding the 1997 calculation were false.

21. E&Y failed to perform adequate audit procedures with regard to the renewal period estimate and the resulting amortization period. Rather, E&Y simply carried forward the 1997 estimates pertaining to the average renewal period. Given the critical nature of this accounting estimate, E&Y's failure to obtain from the Company an update or to arrive at its own independent estimate constitutes a departure from GAAS.

22. E&Y knew or should have known that Bally's 2001 and 2002 financial statements were not presented in conformity with GAAP, and it failed to qualify its opinion or issue an adverse opinion as required by GAAS.

E&Y Seeks To Reduce Its Risk: 2002-2003

23. In 2001 and 2002, a series of widely-known financial scandals led E&Y to assess its audit risks and the firm took steps to identify and resign from or focus on certain of its riskiest clients. Internally, E&Y was communicating the dangers of retaining high risk clients, but even though E&Y identified Bally as one of its riskiest clients during the 2002 client continuance process, E&Y did not resign from Bally. Instead, E&Y tried to reduce the risk that Bally's accounting practices posed to E&Y by, among other things, insisting for the first time that Bally record the numerous accounting errors that had "historically been [placed by E&Y] on the summary of audit differences."

24. In addition, as a result of the implementation of the "Focus Accounts" program, Bally, its accounting, and its retention as an E&Y client came under scrutiny from E&Y regional and national management. E&Y's National Office actively participated in events relating to

Bally's critical accounting issues. From July 2002 through March 2003, E&Y had numerous internal communications and meetings regarding the risks posed by Bally generally, as well as particular risky accounting issues, including, among other things, Bally's revenue recognition estimates. Bally was the subject of a series of meetings with E&Y management, and Bally was placed on a list of National Focus Accounts for Americas Executive Board attention.

E&Y Knew or Should Have Known Bally Made False and Misleading Disclosures Regarding a $55 Million Charge in Fiscal Year 2002

25. As of 2002, Bally's allowance for doubtful accounts ("ADA") had long been on E&Y's list of concerns regarding aggressive accounting. Bally's estimate of the ADA was another area in which management's estimates appeared aggressive. Year in and year out, from 1997 through 2002, Bally consistently used a 41% reserve rate, despite changes in the economy and in market conditions. The resulting ADA was always at the low end of the range that E&Y had deemed to be reasonable.

26. During the third quarter of 2002, E&Y determined that Bally's collections had deteriorated substantially, and E&Y advised Bally that it needed to increase its ADA in order to cover the shortfall resulting from the deteriorating collections. Bally insisted that no change be made to the ADA until the fourth quarter to allow it time to obtain waivers of debt covenants provisions from Bally's lenders.

27. During the fourth quarter of 2002, Bally agreed to increase its ADA by $55 million and ultimately presented it as a "special charge" in Bally's year-end financial statements. In its 2002 Form 10-K, Bally made false and misleading disclosures regarding the reasons for the charge, and E&Y knew or should have known that the disclosures were improper. The only reason for the charge cited in the Form 10-K was that Bally's estimation was based on an accelerated monetization scenario which would result in collecting less than book value. No mention was made of the deterioration of the collectability of Bally's accounts receivable portfolio, which had been identified by E&Y as requiring Bally to take a charge.

28. The $55 million special charge virtually eliminated Bally's 2002 earnings. E&Y knew or should have known that Bally's disclosures failed to disclose accurately the reasons for the "special charge," yet E&Y did not object. E&Y also failed to tell Bally's Audit Committee about Bally's false and misleading disclosures.

Bally's Accounting Errors and E&Y's Audit Failures Relating to Fiscal Year 2003

29. In March 2003, after the 2002 audit had concluded but before the company had filed its 2002 Form 10-K, E&Y contemplated resigning from the Bally engagement "due to risk issues." E&Y decided against resigning in favor of staying on and reducing its risk.

30. Following the decision to remain as Bally's auditor, a new E&Y audit engagement partner rotated on to the Bally engagement in April 2003. The new engagement partner, who was selected because he was experienced and capable of delivering tough messages, was instructed to "fix this situation to reduce the firm's risk."

Recognition of Reactivation Revenue

31. In June 2003, Bally was in the process of refinancing its bank debt through a private debt offering, to be followed by a public exchange offering. In connection therewith, Bally needed E&Y to provide a comfort letter to the underwriters and a consent regarding Bally's use of E&Y's unqualified audit opinion relating to the 2002 audit. E&Y told Bally that unless it stopped accruing reactivation revenue, E&Y would not provide those documents, which left Bally with no real alternative but to agree to stop accruing reactivation revenue. Even though a few months earlier E&Y had issued an unqualified audit opinion regarding Bally's 2002 financial statements that included its reactivation revenue accrual, in a June 16, 2003 meeting, E&Y demanded that Bally change its reactivation accounting. That same day, after the audit team consulted with E&Y's National Office, E&Y agreed to provide Bally with a preferability letter stating that the proposed change in reactivation accounting to a cash basis was a more preferable method of accounting for reactivation revenues.

32. E&Y knew or should have known that Bally's change in accounting for reactivation revenues was not, in fact, a change in accounting, but rather was a correction of an error that required a restatement because Bally's original accrual methodology was not in conformity with GAAP. A change in accounting can only be used to move from a GAAP-compliant accounting methodology to a more preferable GAAP-compliant accounting methodology; errors in previously issued financial statements cannot be corrected through an accounting change. Bally's 2003 financial statements, therefore, improperly included a cumulative effect charge of $20.3 million associated with its change in accounting principle when its prior years' financial statements should have been restated. Accordingly, Bally's 2003 financial statements were not presented in conformity with GAAP, yet E&Y issued an unqualified audit opinion on Bally's 2003 financial statements.

Recognition of Initiation Fee Revenue

33. For the year-end 2003 audit, E&Y turned its attention to Bally's other accounting estimates, including the member life estimates used in determining the amortization period of initiation fees that E&Y knew or should have known were not in conformity with GAAP. E&Y had repeatedly identified as a "critical accounting policy" Bally's initiation fee revenue recognition methodology. Given the concerns about fraud perpetrated by means of accounting estimates, for the 2003 audit, E&Y planned to focus its attention on Bally's membership revenue recognition methodology.

34. E&Y's audit planning reflected its awareness that Bally had failed to update its member life estimate since 1997 and that the company had ignored both its commitment to the Commission staff to do so and E&Y's repeated recommendations to do so. Consistent with its audit planning concerns about Bally's aggressive estimates and the risk of financial fraud, E&Y requested that Bally provide support for the member life estimate for the 2003 fiscal year. Despite repeated efforts to obtain the information, E&Y never received the requested support.

35. Rather than continuing to press Bally for support for its complex accounting estimates, at a meeting on January 25, 2004, E&Y encouraged Bally to change its complex

accounting methods, including initiation fee revenues. E&Y prepared an agenda for the January 2004 meeting with Bally; four of the five agenda items related to identified audit adjustments totaling approximately $260 million.

36. At the January 2004 meeting, E&Y notified Bally that it would have to take a charge relating to new accounting guidance that Bally had failed to implement during the third quarter of 2003. E&Y also identified three adjustments that Bally would have to book. E&Y made clear that the new accounting guidance would require Bally to apply a modified cash basis of accounting to some of its contracts. As Bally and E&Y discussed the proposed change, Bally's CFO proposed adopting a modified cash basis of accounting for all of the company's membership contracts. E&Y knew or should have known that the change to a modified cash basis for the rest of Bally's revenue recognition accounting would allow Bally to avoid or at least reduce the significance of some of the charges E&Y had identified. The proposed changes would also subsume some of the prior audit failures relating to initiation fee revenues. Bally changed its accounting and E&Y issued a preferability letter that it knew or should have known enabled Bally to improperly avoid a restatement.

37. Bally's change from accrual accounting to a modified cash basis of accounting was not, in fact, a change in accounting, but rather involved a correction of an error that required a restatement because Bally's implementation of the deferral method for recognition of initiation fee revenue was not in conformity with GAAP. Accordingly, Bally's 2003 financial statements were not presented in conformity with GAAP, but E&Y nonetheless issued an unqualified audit opinion on Bally's 2003 financial statements.

E&Y's Audit Was Deficient and Not Performed in Accordance with GAAS

38. E&Y's 2003 audit was deficient and not performed in accordance with GAAS. E&Y failed to obtain sufficient competent evidential matter to support an opinion that Bally's estimates, including the average member life estimates, were reasonable. E&Y told Bally's audit committee that GAAS prescribed certain "mandatory procedures," including: "reviewing accounting estimates for biases that could result in material misstatement due to fraud, including retrospective review of significant prior year estimates. . . ."

39. E&Y also did not follow up on evidence that Bally's average member life estimates were biased and unsubstantiated.

40. The change in accounting to a modified cash basis resulted in Bally recording a cumulative effect adjustment ("CEA") of more than $441 million, which was much more than the effect of the identified audit adjustments referred to above, but allowed Bally to provide a positive explanation for the effect. Given that a significant amount of the CEA related to how Bally had amortized the initiation fees over a period of less than two years, E&Y should have questioned how two supposedly GAAP-compliant methodologies resulted in such a material disparity in earnings. Nonetheless, E&Y failed to do so. If it had followed up, E&Y would have determined that Bally's prior calculation of the member life estimates was not reasonable and the

Company's straight-line amortization of the financed membership initiation fees over a 22-month period was not in conformity with GAAP.

41. Just as E&Y's issuance of a preferability letter with regard to the change in accounting for reactivation dues was improper, so too was its issuance of a preferability letter with regard to the change to a modified cash basis for initiation fees. By the time E&Y began the 2003 audit, E&Y was aware of the issues associated with the average member life estimate that required vigorous audit procedures, yet E&Y failed to respond adequately.

42. E&Y knew or should have known that Bally's 2003 financial statements were not presented in conformity with GAAP, and it failed to qualify its opinion or issue an adverse opinion as required by GAAS.

Legal Analysis

43. Section 17(a)(2) of the Securities Act prohibits obtaining money or property by means of untrue statements of material fact or misleading omissions of material fact in the offer or sale of securities. Section 17(a)(3) of the Securities Act prohibits engaging in transactions, practices or courses of business which operate or would operate as a fraud or deceit upon the purchaser in the offer or sale of securities. Information is material where there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Establishing violations of Section 17(a)(2) and 17(a)(3) does not require a showing of scienter. *Aaron v. SEC*, 446 U.S. 680, 697 (1980).

44. Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11 and 13a-13 thereunder require all issuers with securities registered under Section 12 of the Exchange Act to file annual, current and quarterly reports on Form 10-K, Form 8-K and Form 10-Q, respectively. Exchange Act Rule 12b-20 further requires that, in addition to the information expressly required to be included in such reports, the issuer must include such additional material information as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading. The obligation to file these periodic reports includes the obligation that they be complete and accurate in all material respects. *See, e.g.*, SEC v. IMC Int'l, Inc., 384 F. Supp. 889, 893 (N.D. Tex.), aff'd mem., 505 F.2d 733 (5th Cir. 1974), cert. denied sub nom. No showing of scienter is necessary to establish a violation of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13 and 12b-20. *See SEC v. McNulty*, 137 F.3d 732, 740-741 (2d Cir. 1998).

45. Section 13(b)(2)(A) of the Exchange Act requires issuers to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."

47. Bally violated Section 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder by, among other things, prematurely recognizing income and improperly deferring costs which resulted in its books and records being false, failing to maintain accurate books and records and

including material, false and misleading financial statements and information in annual, quarterly and current reports filed with the Commission in connection with fiscal years 2001 through 2003.

48. E&Y's failure to comply with GAAS was a cause of and aided and abetted Bally's violations. For each of the years 2001-2003, E&Y issued audit reports containing unqualified opinions stating that E&Y had conducted an audit of the company's annual financial statements in accordance with GAAS, that Bally's financial reporting was in conformity with GAAP, and that Bally's reported results fairly represented the financial condition of the company. E&Y consented to the inclusion of these audit reports in Bally's Forms 10-K for 2001-2003. However, E&Y's audit reports were misleading because E&Y failed to conduct its audits in accordance with GAAS. E&Y also knew or should have known that Bally was engaged in non-GAAP and other accounting actions that were not disclosed to investors and prevented Bally's reported financial results from fairly representing its financial condition.

49. In auditing Bally's accounting practices relating to reactivation revenue and initiation fee revenue, E&Y failed under GAAS to exercise due professional care and skepticism, failed to obtain sufficient competent evidential matter and substituted managements' representations for competent evidence supporting the accounting. In fact, E&Y never insisted that Bally provide support for certain of these estimates, nor did E&Y itself perform sufficient audit procedures to test and determine whether these accounting actions resulted in appropriate revenue. Had it done so, it would have reasonably determined that these accounting practices were not in conformity with GAAP.

50. Despite these accounting and audit failures, and in further violation of GAAS, E&Y did not express a qualified or adverse audit opinion, or refuse by disclaimer to express any opinion at all, but instead issued audit reports that contained unqualified opinions on Bally's 2001-2003 financial statements. E&Y also knew or should have known that Bally was making false and misleading disclosures such as in connection with its $55 million special charge. Nor did E&Y propose that Bally correct its improper accounting in the quarterly financial statements that E&Y reviewed during 2001-2003. E&Y also improperly issued preferability letters that allowed Bally to switch its reactivation accounting and initiation fee revenue accounting instead of restating for errors relating to that accounting. Accordingly, E&Y's failure to comply with GAAS was a cause of and aided and abetted Bally's violations of Section 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder.

51. E&Y also willfully violated Section 10A(b) of the Exchange Act in connection with Bally's failure to disclose that the $55 million special charge recorded in its FY 2002 financial statements was due to a deterioration in the collectability of the Company's receivables. E&Y failed to report this illegal act to the Audit Committee in accordance with Section 10A(b).

Findings

As a result of the conduct described above, E&Y willfully[4] violated Section 10A(b) of the Exchange Act and was a cause of and willfully aided and abetted Bally's violations of Section 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder.

Undertakings

Respondent has agreed to the following undertakings:

A. <u>Undertaking Concerning a Payment in the Nature of a Penalty</u>

E&Y shall, within 10 days of the entry of an Order, make a payment in the nature of a penalty in the amount of $8.5 million 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 E&Y as a Respondent 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 Kenneth R. Lench, Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Washington, D.C. 20549.

B. <u>Undertaking Concerning Ongoing Cooperation</u>

E&Y agrees that E&Y (including its partners, principals, officers, agents and employees) shall cooperate fully with the Commission with respect to any matter relating to the Commission's investigation of Bally, including but not limited to any litigation or other proceeding related to or resulting from that investigation. Such cooperation shall include, but is not limited to:

(a) production of information-- at the Commission's request, upon reasonable notice, and without subpoena, E&Y (including its partners, principals, officers, agents and employees) shall truthfully and completely disclose all information requested by SEC staff in connection with the Commission's investigation, litigation or other proceedings, except with respect to information related to clients other than Bally, which information shall be produced in response to subpoena;

(b) production of documents -- at the Commission's request, upon reasonable notice, and without subpoena, E&Y (including its partners, principals, officers, agents and

[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)).

employees) shall provide any document, record, or other tangible evidence requested by SEC staff in connection with the Commission's investigation, litigation or other proceedings, except with respect to documents related to clients other than Bally, which documents shall be provided in response to subpoena;

(c) production of cooperative personnel -- at the Commission's request, upon reasonable notice, and without subpoena, E&Y (including its partners, principals, officers, agents and employees) shall use its best efforts to secure the attendance and truthful statements or testimony of any E&Y partner, principal, officer, agent, or employee, excluding any such person who is a party to litigation with the Commission, at any meeting, interview, testimony, deposition, trial, or other legal proceeding.

The foregoing obligations are subject to E&Y's reservation of rights:

(i) to claim that documents or information requested is subject to attorney client privilege or attorney work-product protection; and

(ii) to seek entry of a confidentiality order as to (aa) sensitive business documents or information, (bb) sensitive personnel documents or information, or (cc) confidential information pertaining to clients other than Bally.

C. Undertakings Concerning Auditing Matters

1. *National Office Consultations.* The goal of this undertaking is for E&Y to avoid circumstances under which a member of the National Office Professional Practice group, or any person in a comparable position, is consulted on a matter for which he or she may lack sufficient objectivity based on prior involvement with the same client. E&Y shall adopt, implement and enforce written policies and procedures to provide reasonable assurances that no member of the Professional Practice group, or any person in a comparable position, engages in a consultation on an accounting, auditing, reporting or other issue relating to an audit or review of a public company client, if that member or person currently serves, or within the prior seven years has served, as a member of the engagement team or an independent or engagement quality review partner for such client; notwithstanding the foregoing, any person excluded based on prior involvement may provide background factual information relating to the client, or may inform others providing the consultation of the applicable technical guidance relating to issues that are not the same as or similar to issues with which the person was previously involved at the client.

2. *High Risk Clients*. The goal of this undertaking is to require E&Y to adopt, implement and enforce written policies and procedures to provide reasonable assurances that E&Y National Office Professional Practice partners, or persons in comparable positions, engaged in risk management roles do not lack sufficient objectivity because of their current or prior duties or responsibilities with respect to clients identified as presenting high risk to E&Y, including without limitation all Focus Account clients. Such policies and procedures shall require, at a minimum, that any partner who currently serves as, or has served as within the prior

seven years, a member of the engagement team or an independent or engagement quality review partner for such client, shall refrain from the exercise of the risk management duties and responsibilities of a National Office Professional Practice partner, or of a comparable position, with respect to such client identified as presenting high risk to E&Y; notwithstanding the foregoing, any person excluded based on prior involvement may provide background factual information relating to the client, or may inform others of the applicable technical guidance relating to issues that are not the same as or similar to issues with which the person was previously involved at the client.

3. *Preferability Letters.* The purpose of this undertaking is to require E&Y to engage in an internal review of its existing policies and procedures concerning the issuance of preferability letter opinions, make such revisions as may be necessary, and then engage in steps to implement and enforce such policies and procedures so as to provide reasonable assurances that, prior to the issuance of any preferability letter, E&Y applies sufficient professional scrutiny to, and documents the application of such scrutiny to, requests by public company clients to change to an alternative method of accounting. E&Y shall make such revisions as may be necessary in order to adopt, implement and enforce written policies and procedures, concerning the review and approval of preferability letters issued by E&Y to public company clients, in order to provide reasonable assurances that E&Y complies with all applicable professional standards, regulatory and legal requirements, and E&Y policies. E&Y's obligation hereunder shall include, without limitation, a requirement to document in the audit workpapers a complete analysis as to: (a) whether the prior method of accounting is in conformity with GAAP; (b) whether the new proposed method is in conformity with GAAP; (c) whether the client proposed the change in accounting principle; (d) whether or not the client has provided sufficient justification for the change in accounting principle; and (e) whether or not the change in accounting principle is presented in accordance with GAAP. In addition, E&Y shall make such revisions as may be necessary in order to adopt, implement and enforce written policies and procedures to provide reasonable assurances that that documentation of the review and approval of preferability letters issuable to public company clients, including the review of the aforementioned workpapers, is completed and included in the workpapers prior to the issuance of any such letters.

4. *Documentation of Consultations.* The purpose of this undertaking is to require E&Y to engage in an internal review of its existing policies and procedures concerning documentation of National Office Professional Practice group, or any person in a comparable position, consultations, make such revisions as may be necessary, and then engage in steps to implement and enforce such policies and procedures. E&Y shall make such revisions as may be necessary in order to adopt, implement and enforce written policies and procedures to provide reasonable assurances that workpapers prepared in connection with audits and reviews of the financial statements of public companies include documentation of consultations with E&Y's National Office Professional Practice group, persons in comparable positions, firm specialists or others within or without the firm. The documentation of such consultations shall include a description of the issue considered, any action taken with respect to the issue, and the basis for conclusion with respect to the issue. Such documentation shall be retained for seven years and subject to inspection by the Public Company Accounting Oversight Board. The policies and

procedures also should address documentation of inquiries of employees of public audit clients pertaining to such consultations.

5. *Disagreements and Reportable Events*. The goal of this undertaking is to require E&Y to engage in an internal review of its existing policies and procedures concerning compliance with the provisions of Item 304 of Regulation S-K ("Item 304"). E&Y shall adopt, implement and enforce written policies and procedures providing reasonable assurance that E&Y complies with Item 304, including ensuring that training is provided to E&Y's National Office Professional Practice group, persons in comparable positions and its engagement teams.

6. *Detection and Reporting of Illegal Client Activity (Section 10A Compliance)*. The goal of this undertaking is to require E&Y to engage in an internal review of its existing policies and procedures concerning compliance with Section 10A of the Exchange Act, make such revisions as may be necessary, and then engage in steps to implement and enforce such policies and procedures so as to provide reasonable assurances that E&Y will comply with its obligations under Section 10A. E&Y shall make such revisions as may be necessary in order to adopt, implement and enforce written policies and procedures providing reasonable assurance that E&Y complies with Section 10A of the Securities of Exchange Act of 1934, as amended, including without limitation, for each audit subject to Section 10A, procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts, and to comply with all requirements under the standards of the Commission and the Public Company Accounting Oversight Board and Section 10A to evaluate and report suspected illegal acts.

7. *Certification of Compliance*. The chairman of E&Y shall certify in writing compliance with each of the above undertakings (the "Certificate of Compliance"). The certification shall identify each of the above undertakings with which E&Y believes it has complied and shall provide written evidence of compliance in the form of a narrative which is supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and E&Y agrees to provide such evidence. The certification and supporting material shall be submitted to Assistant Director Kenneth R. Lench of the Division of Enforcement. This certification shall be submitted no later than six months from the date of this order.

8. *Independent Consultant.* No later than 3 months after successfully certifying to the Commission that all of the above undertakings have been completed, E&Y shall select and retain an Independent Consultant, qualified to examine and assess compliance with the above Undertakings Concerning Auditing Matters. In advance of retention by E&Y, the selected Independent Consultant shall be confirmed to be acceptable to the Commission staff. E&Y may not retain as Independent Consultant any individual or entity that has provided legal, auditing or other services to, or has had any affiliation with, E&Y during the prior two years. Moreover, E&Y shall require the Independent Consultant to enter into an agreement that provides that, for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with E&Y, or any of its present or former affiliates, partners,

directors, officers, employees, or agents acting in their capacity as such. The agreement will also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the staff of the Division of Enforcement, enter into any employment, consultant, attorney-client, auditing or other professional relationship with E&Y, or any of its present or former affiliates, partners, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

E&Y shall provide a copy of the complete Certification of Compliance, including all attachments, previously submitted to the Commission staff, together with such other evidence as E&Y may deem appropriate to enable the Independent Consultant to reasonably evaluate E&Y's compliance with the undertakings in this Order and their effectiveness in achieving their stated goals. E&Y shall provide the Independent Consultant with reasonable access to such E&Y personnel, records and information, as the Independent Consultant may request in connection with the Independent Consultant's review.

Following completion of the Independent Consultant's review, the Independent Consultant shall prepare a detailed written report describing the actions taken by E&Y in response to the above undertakings and the effectiveness of such actions, and certifying that (i) E&Y has complied with the above undertakings, and (ii) the undertakings appear to be effective in achieving their stated goals. If the consultant cannot so certify, the consultant shall (i) describe in the written report the reason that the consultant is unable to so certify, (ii) prepare and submit to E&Y written recommendations to E&Y designed to bring E&Y into effective compliance with the goals of the undertakings, and (iii) attach a copy of such written recommendations as an exhibit to the written report. A copy of the Independent Consultant's report, certification and recommendations, if any, shall be submitted to Assistant Director Kenneth R. Lench of the Division of Enforcement within twelve months of the commencement of the Independent Consultant's review, or such additional time as necessary for the Independent Consultant to complete the review and make the required certification.

In determining whether to accept the Offer, the Commission has considered these undertakings. Respondent agrees that if the Division of Enforcement believes that Respondent has not satisfied these undertakings, it may petition the Commission to reopen the matter to determine whether additional sanctions are appropriate.

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act, Sections 4C and 21C of the Exchange Act, and Rule 102(e)(1)(iii) of the Commission's Rules of Practice, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Section 10A of the Exchange Act and Sections 17(a)(2) and (3) of the Securities Act, and from causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder;

B. Respondent is censured pursuant to Rule 102(e)(1)(iii) of the Commission's Rules of Practice;

C. Respondent shall comply with the undertakings enumerated in Section III.C above.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

/

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9097 / December 18, 2009

SECURITIES EXCHANGE ACT OF 1934
Release No. 61200 / December 18, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13726

In the Matter of

ICAP Securities USA LLC,
Ronald A. Purpora,
Gregory F. Murphy,
Peter M. Agola,
Ronald Boccio,
Kevin Cunningham,
Donald E. Hoffman, Jr., and
Anthony Parisi

Respondents.

ORDER INSTITUTING 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, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to 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 ICAP Securities USA LLC ("ICAP"); pursuant to Section 8A of the Securities Act and Section 15(b) of the Exchange Act against Peter M. Agola ("Agola"), Ronald Boccio ("Boccio"), Kevin Cunningham ("Cunningham"), Donald E. Hoffman, Jr. ("Hoffman"), and Anthony Parisi ("Parisi," and with Agola, Boccio, Cunningham, and Hoffman, collectively, the "Brokers"); and pursuant to Section 15(b) of the Exchange Act against Ronald A. Purpora ("Purpora") and Gregory F. Murphy ("Murphy") (all collectively, "Respondents").

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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 over the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting 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, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds[1] that:

A. SUMMARY

1. This matter concerns deceptive broking activity and material misrepresentations concerning trading by ICAP, a wholly-owned U.S. subsidiary of U.K.-based ICAP plc, the world's largest inter-dealer broker ("IDB"), on its voice-brokered US Treasuries ("UST") desks and its voice-brokered collateral pass-through mortgage-backed securities ("MBS") desk, and by several individuals employed by ICAP.

2. On the UST desks, ICAP, through the Brokers, engaged in deceptive conduct by displaying fictitious "flash" trades on ICAP's screens seen by its UST customers, who took that information into account in making their trading decisions. In addition, the firm represented to its customers that the ICAP trading screens would handle customer orders in accordance with certain workup protocols, which the firm and the Brokers circumvented when Brokers used manual tickets to liquidate house positions that were acquired through error trades or through ICAP's posting of executable bids and offers. Between December 1, 2004 and December 31, 2005, certain ICAP UST brokers displayed thousands of fictitious trades on ICAP's screens, and used manual tickets in thousands of instances to close out of house inventory positions acquired as a result of error trades or through ICAP's posting of executable bids and offers, in certain of which instances ICAP's customers' orders received different treatment than the customers expected pursuant to the workup protocols.

[1] The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

3. On the MBS desk, contrary to representations by ICAP in regulatory filings and elsewhere that its primary business is to match buyers and sellers and serve as a "riskless principal" between customer trades, at least two former brokers, the manager and assistant manager of the MBS desk, (the "MBS Desk Manager" and "MBS Desk Assistant Manager," respectively) engaged in profit-seeking trading for their ICAP house account between January 2005 and June 2008. Such profit-seeking trading activity was against ICAP policy at least as of April 1, 2007.

4. During the relevant period, the employees on the UST desks were supervised by respondent Purpora (ICAP's President) and respondent Murphy (ICAP's Chief Operating Officer). Both Purpora and Murphy failed reasonably to supervise the Brokers.

5. Finally, ICAP failed to make and keep for prescribed periods such records as required by Section 15C of the Exchange Act and 17 CFR Parts 404 and 405.

B. RESPONDENTS

6. ICAP, formerly d/b/a Garban LLC, is located in Jersey City, New Jersey. ICAP is a member of FINRA and has been registered with the Commission since 1987 as a government securities broker-dealer under Section 15C of the Exchange Act. ICAP is, and has been since 1999, an indirect wholly-owned subsidiary of ICAP plc, a FTSE 100 company registered in the United Kingdom.

7. Purpora, age 53, is a resident of Staten Island, New York. Purpora has been employed by ICAP and its predecessor firms since 1975, and over the years he has held various positions. Most recently, from 2007 until July 1, 2009, Purpora was the President of ICAP North America ("ICAP NA") and its wholly-owned subsidiaries ICAP, ICAP Corporates, Intercapital Securities, and First Brokers. Additionally, from 2006 to 2007, Purpora was the Chief Operating Officer of ICAP NA. From 2002 to 2006, Purpora was the Co-Chief Executive of the predecessor firm to ICAP NA, and the President of its wholly-owned subsidiaries, including ICAP. Throughout the relevant time period, Purpora was a member of ICAP plc's Global Executive Management Group. On July 1, 2009, Purpora was made a Director of ICAP NA, with no supervisory responsibilities. As of January 1, 2010, Purpora will be a consultant to ICAP NA. Purpora holds Series 3 and 24 licenses.

8. Murphy, age 47, is a resident of Oceanport, New Jersey. Murphy has been employed by ICAP and its predecessor firms since 1985. Since 2002, Murphy has been the Chief Operating Officer of ICAP and ICAP Corporates. Murphy holds Series 3, 7, 24, 27, 62, and 63 licenses.

9. Agola, age 46, is a resident of Brightwaters, New York. Agola has been employed by ICAP since 1986, except for a year when he was a broker at another IDB from 1989-1990. Since 1990, Agola has been a broker on the UST long bond desk, and he became the assistant manager of the desk in 2005. Agola holds a Series 3 license.

10. Boccio, age 55, is a resident of Matawan, New Jersey. Boccio has been employed by ICAP and its predecessor firms since 1980. Boccio has been a broker on the UST 5 year desk since approximately 1991.

11. Cunningham, age 52, is a resident of Garden City, New York. Cunningham has been employed by ICAP and its predecessor firms since 1986. Cunningham has been on the UST shorts desk since 1989, and has been the manager of the desk since July 2005. Cunningham holds Series 3, 7, 55, and 63 licenses.

12. Hoffman, age 56, is a resident of Millerton, Pennsylvania. Hoffman was employed by ICAP and its predecessor firms from 1976 to 1991, and from 1992 until he retired in 2006. From 1991 to 1992, Hoffman operated an office supply store. When he returned to ICAP in 1992, Hoffman worked on the UST 10 year desk as a broker until 2006. While at ICAP, Hoffman held a series 7 license.

13. Parisi, age 51, is a resident of Plandome, New York. Parisi has been employed by ICAP and its predecessor firms since 1989, and has been the co-manager of the 5 year UST desk throughout that time.

C. <u>INTER-DEALER BROKERS</u>

14. IDBs match buyers and sellers in over-the-counter markets such as treasury securities, mortgage-backed securities, agencies, corporates, and credit derivatives. IDBs are paid commissions for trades that are completed by their customers, who are primary dealers and other large financial institutions.[2] IDBs in the matched principal markets often provide anonymity to their customers who do not want their identities known to the rest of the small pool of market participants. In some markets, such as US Treasuries, an IDB's customer's identity is not revealed to its other customers, whereas in other markets, such as mortgage-backed securities, the customer's identity is revealed to the counterparty several days after the trade has been completed for settlement. In both of these "matched principal" markets, the IDB acts as an intermediary and a counterparty for back-to-back matched trades. In other words, an IDB's role in such markets is to buy from the offeror, and to sell to the bidder. ICAP refers to its role in such markets as a "riskless principal," meaning that it has no economic risk except for a circumstance where a counterparty fails to perform its obligation at settlement.

15. The IDB marketplace is dominated by a handful of firms that engage in "voice" and/or "electronic" broking. Since 2005, ICAP plc (and its electronic broker, ICAP Electronic Broking f/k/a BrokerTec USA LLC) has been the largest IDB, with nearly a one-third market share across all products world-wide, and a two-third share of the market for US Treasuries. Each voice-broking IDB has its own screens reflecting certain trading information –

[2] Representatives of the IDBs' customers are referred to here as "traders" to distinguish them from "brokers" who are the employees of the IDB.

bids (offers to buy), offers (offers to sell), price, volume, and its customers' account numbers. The IDB's customers' traders have access to the IDB's screens, which reflect all of the foregoing trading information except customer account numbers. Historically, IDBs were only "voice-based," meaning that they took customer orders over the telephone. Now, most IDBs have significant business on their proprietary electronic trading platforms where customers enter their own trades electronically (this is especially true in extremely liquid markets like active-issue US Treasury trading). A portion of ICAP's voice-broking business is "hybrid," meaning that traders have the option to either execute trades themselves on ICAP's screen, or to call a broker and have the broker execute trades on their behalf.

16. While on-the-run, or active, extremely liquid treasury issues are traded almost exclusively electronically through ICAP's electronic broking system, the off-the-run, older treasury securities are voice-brokered by several desks, referred to as: 5 Years; 10 Years; Zeros/Long Bonds; Shorts (2-3 years); Short-Shorts (under 2 years); Yield Curve Swap (eliminated in February 2006); and Bills. On these desks, ICAP posts executable bids and offers on its screens usually at minimum size increments in order to encourage trading by its customers. As part of this process, ICAP, at times, ends up with a position, and the liquidation of such a position may result in a gain or loss. As of December 2005, there were approximately 56 brokers on these desks, including a manager (who also functioned as a broker) on each desk who reported to Purpora and Murphy.

17. ICAP's mortgage-backed securities desks were organized differently than the UST desks, with all six of the desks reporting to the MBS Desk Manager. The MBS Desk Assistant Manager worked on the MBS desk only. There were approximately a dozen brokers on the MBS desk who reported to the MBS Desk Manager.

D. THE VIOLATIVE BROKING PRACTICES AND MISREPRESENTATIONS

18. At various points between December 2004 and December 2005, ICAP, through certain UST brokers, engaged in improper broking practices referred to herein as "fictitious flash trades," and liquidated house positions that made its representations regarding certain workup protocols misleading. Between December 2004 and June 30, 2008 (the "Relevant Period"), ICAP, through certain MBS brokers, also engaged in trading that made its representations regarding abstaining from profit-seeking trading for its own account false and misleading.

Fictitious Flash Trades

19. ICAP, through its brokers on the UST desks, displayed fictitious flash trades on ICAP's screens seen by its UST customers, thereby disseminating false trade information into the marketplace. These trades (also known as "bird" trades) appeared to customers viewing ICAP's screens to be real trades. However, the fictitious flash trades were not real trades as ICAP brokers used two house accounts to generate the flash and then cancelled the trades before they were sent to ICAP's back office for processing. Between December 1, 2004 and December 31,

2005, ICAP's UST brokers knowingly or recklessly displayed thousands of fictitious flash trades to ICAP's customers.

20. In order to attract ICAP's customers' attention to ICAP screens and to encourage actual trading by such customers, ICAP, through the respondent Brokers, engaged in fictitious flash trading. The Brokers flashed fictitious trades at what they believed was the market price in order to make the flash trade appear to be a real trade to the customers. The Brokers admitted that the flash trades were not real trades, and that customers had no way of knowing whether the trades appearing on ICAP's screens were real trades or fictitious trades. ICAP and the Brokers failed to disclose to ICAP's customers that some of the trades on ICAP's screens were fictitious flash trades.

21. ICAP's customers believed that trades on ICAP's screens reflected trades between customers. Trades appearing on ICAP's screens informed ICAP's customers' views of the market and their trading decisions.

Misrepresentations Regarding Certain Workup Protocols

22. ICAP represented to its off-the-run UST customers that ICAP's electronic trading system would follow certain workup protocols in handling customer orders. As a result, ICAP's off-the-run UST customers expected that their orders, once entered onto ICAP's screens, would be filled according to the workup protocols. However, between December 2004 and December 2005, ICAP, through its brokers on the UST desks, liquidated thousands of positions acquired through error trades or by posting executable bids and offers by the use of manual tickets that rendered its representations regarding workup protocols false and misleading.

23. Each of the respondent Brokers knowingly or recklessly used manual tickets to bypass the workup protocols in certain instances when they wanted to close out of a position they had in their ICAP house account acquired as a result of error trades or through ICAP's posting of executable bids and offers. In certain of such cases, ICAP's customers' orders received different treatment than the customers expected pursuant to the workup protocols.

Misrepresentations Regarding Proprietary Trading By Two MBS Brokers

24. During the Relevant Period, two former ICAP brokers – the MBS Desk Manager and the MBS Desk Assistant Manager – engaged in proprietary trading for their ICAP house account that rendered ICAP's representations regarding proprietary trading false and misleading. In June 2008, after the Commission's investigation focused on the MBS desk, ICAP suspended the MBS Desk Manager and the MBS Desk Assistant Manager, terminating them in September 2008, for, among other things, proprietary trading in violation of ICAP's policies.

25. In or around 2005, the MBS Desk Manager negotiated with ICAP to increase, from 40% to 50%, the share of profits from their house account that the MBS Desk Manager and the MBS Desk Assistant Manager would collectively receive as a bonus. The MBS

Desk Manager and the MBS Desk Assistant Manager engaged in profit-seeking proprietary trading for their ICAP house account from January 2005 through June 2008.

26. At various times during the Relevant Period, ICAP held itself out as a firm that did not engage in profit-seeking trading that subjected its own capital to risk. For example, ICAP's annual Form G-405 ("FOGS") reports (a periodic filing required of government securities brokers and dealers registered pursuant to Section 15C of the Exchange Act), for ICAP's fiscal years ending March 31, 2005 through 2007, state that the Company (which includes ICAP and its two subsidiaries) "is a broker of United States Treasury bills, notes, bonds … on a fully matched basis," and the attached income statements fail to report any revenues from any trading. The reports also state that the Company "generally executes transactions as a riskless principal between undisclosed principals," with the only described exception being a counterparty's failure to perform its obligation at settlement.

27. The FOGS report for the year ending March 31, 2008 states that, "[i]n the normal course of business, the Company generally executes transactions as a riskless principal between undisclosed principals." Elsewhere, the FOGS report also notes the Company "does not engage in proprietary trading."

28. ICAP's quarterly FOGS report, for the period ending March 31, 2008 fails to list any revenue in the mandatory reporting categories of "gains or loses on firm securities trading accounts" and "all other trading" even though during this three-month period the MBS desk's house account generated significant profits.

29. As a result of the above representations, coupled with the conduct of the MBS Desk Manager and the MBS Desk Assistant Manager, during the Relevant Period, ICAP's customers were misled about the extent of ICAP's trading activities on its MBS desk, and, as a result, such customers were not able to make fully informed trading decisions. In addition, during the Relevant Period, ICAP filed inaccurate FOGS Reports with respect to house account positions on the MBS desk.

E. <u>BOOKS AND RECORDS VIOLATIONS</u>

30. During the Relevant Period, ICAP failed to make and keep for prescribed periods certain required records. Between December 1, 2004 and December 31, 2005, on the UST desks, with respect to the flash trading, the cancelled order tickets were discarded. During the same period, with respect to the Brokers' use of manual tickets in contravention of the workup protocols, ICAP did not preserve all required records concerning unfilled customer orders.

31. During the Relevant Period, the trading records on ICAP's MBS desk similarly were deficient. MBS brokers maintain individual handwritten blotters, which are consolidated into a handwritten "master" desk blotter. A clerk enters the trades from the handwritten master desk blotter into ICAP's electronic system. During the Relevant Period, when MBS brokers changed or canceled a trade, they were inconsistent in their practice of noting the

change if they noted the change at all. In numerous instances, the master desk blotter did not match the electronic trading records sent to the back office.

F. FAILURE TO SUPERVISE RESPONDENT BROKERS

32. During the Relevant Period, Purpora and Murphy supervised the Brokers on the UST desks. Each of them failed reasonably to supervise the Brokers with a view to preventing and detecting the Brokers' violations of the federal securities laws. Despite red flags, Purpora and Murphy failed to prevent and detect the Brokers' flashing fictitious trades until after the conduct had been uncovered by the Commission's investigation. Purpora knew that flash trading had occurred years prior to the Relevant Period, and he monitored ICAP's trading screens. Murphy had conversations with some ICAP personnel about the practice of flashing fictitious trades, yet Murphy did not take steps to inquire further of the Brokers about the practice. The practice of flashing fictitious trades continued until December 2005, when it was prohibited by ICAP when such conduct was brought to ICAP's attention as a result of the staff's investigation.

33. Both Purpora and Murphy were aware that the Brokers used manual tickets, but failed to inquire into the Brokers' practices concerning the use of manual tickets to circumvent the workup protocols concerning customer orders.

G. VIOLATIONS

34. As a result of the conduct described above, ICAP willfully[3] violated Section 17(a)(2) and 17(a)(3) of the Securities Act, which prohibit any person from obtaining money "by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading" or engaging "in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser" in the offer or sale of securities. Moreover, as a result of the conduct described above, ICAP willfully violated Section 15C of the Exchange Act and 17 CFR Parts 404 and 405, which require certain records and reports to be made, preserved, and filed by government securities brokers and dealers.

35. As a result of the conduct described above, Agola, Boccio, Cunningham, Hoffman, and Parisi each willfully aided and abetted and caused ICAP's violations of Section 17(a)(2) and 17(a)(3) of the Securities Act, which prohibit any person from obtaining money "by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading" or engaging "in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser" in the offer or sale of securities.

[3] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)).

36. As a result of the conduct described above, Purpora and Murphy failed reasonably to supervise Agola, Boccio, Cunningham, Hoffman, and Parisi, each of whom willfully aided and abetted and caused ICAP's violations of Section 17(a)(2) and 17(a)(3) of the Securities Act, with a view toward preventing their violations of the federal securities laws within the meaning of Section 15(b)(6) of the Exchange Act, which incorporates by reference Section 15(b)(4)(E) of the Exchange Act.

Respondents' Remedial Efforts

In determining to accept the Offers, the Commission considered remedial acts promptly undertaken by Respondents and cooperation afforded the Commission staff.

Undertakings

Respondent ICAP has undertaken to:

37. Within 90 days of the date of this Order, ICAP shall retain an independent consultant ("IC"), not unacceptable to the staff of the Commission to:

(a) conduct a review of:

(i) ICAP's current controls and compliance mechanisms;

(ii) the trading activities on all desks at ICAP to ensure that the violations described herein are not presently occurring at ICAP; and

(iii) ICAP's books and records pertaining to trading records.

(b) recommend any additional policies and procedures which, on the basis of its review, the IC believes are reasonably designed to ensure that ICAP complies with applicable provisions of the federal securities laws with respect to the violations described herein (the "Recommendations");

(c) submit to ICAP and the staff of the Commission, within 30 days of the completion of its review, and in any event no later than 180 days after being retained by ICAP, a report describing the scope and results of the IC's review, and the Recommendations, if any, made by the IC to ICAP;

(d) conduct a follow-up review commencing no earlier than 120 days after completion of the report described in (c) above to determine if the Recommendations (either in their original form or modified pursuant to paragraph 38 below) were properly implemented by ICAP and are operating to ensure ICAP's compliance with applicable provisions of the federal securities laws;

(e) submit to the staff of the Commission, within 30 days of the completion of the follow-up review, and in any event no later than 360 days after being retained by ICAP, a follow-up IC report describing the results of the IC's follow-up review.

38. ICAP shall adopt all Recommendations of the IC; provided, however, that within 45 days of the completion of the review described in paragraph 37(a) above, ICAP shall in writing advise the IC and the staff of the Commission of any Recommendations that it considers to be unnecessary, inappropriate, or unduly burdensome. With respect to any Recommendation that ICAP considers unnecessary, inappropriate, or unduly burdensome, ICAP need not adopt that Recommendation at that time but shall propose in writing an alternative policy, procedure or system designed to achieve the same objective or purpose. As to any Recommendation on which ICAP and the IC do not agree, such parties shall attempt in good faith to reach an agreement within 30 days after ICAP serves the advice described above. In the event that ICAP and the IC are unable to agree on an alternative proposal, ICAP will abide by the determinations of the IC. The Commission staff shall have the authority, in its discretion, to extend, at the joint written request of ICAP and the IC, the dates set forth in this paragraph and in paragraph 37 above.

39. ICAP shall not have the authority to terminate the IC without the prior written approval of the staff of the Commission. ICAP shall compensate the IC, and persons engaged to assist the IC, for services rendered, at their reasonable and customary rates. ICAP shall not be in, and shall not have, an attorney-client relationship with the IC and shall not seek to invoke the attorney-client privilege or any other doctrine or privilege to prevent the IC from transmitting any information, reports, or documents to the staff of the Commission.

40. ICAP shall require the IC to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the IC shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with ICAP, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the IC will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the IC in performance of his/her duties under this Order shall not, without prior written consent of the staff of the Commission, enter into any employment, consultant, attorney-client, auditing or other professional relationship with ICAP, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

41. Respondents Agola, Boccio, Cunningham, Hoffman, Parisi, Purpora, and Murphy shall each provide to the Commission, within 30 days after the end of the 3-month suspension periods described below in Section IV, an affidavit that he has complied fully with this sanction.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offers.

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

A. Pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Respondent ICAP shall cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) and 17(a)(3) of the Securities Act, Section 15C of the Exchange Act and 17 CFR Parts 404 and 405;

B. Pursuant to Section 15(b)(4) of the Exchange Act, Respondent ICAP is censured;

C. Respondent ICAP shall, within thirty (30) days of the entry of this Order, pay disgorgement of $1 million and a civil money penalty in the amount of $24 million to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 31 U.S.C. 3717. 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 ICAP 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 Sanjay Wadhwa, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, Room 400, New York, NY 10281-1022; and

D. Respondent ICAP shall comply with the undertakings enumerated in Paragraphs 37 through 40 above.

E. Pursuant to Section 8A of the Securities Act, respondents Agola, Boccio, Cunningham, Hoffman and Parisi shall cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) or 17(a)(3) of the Securities Act;

F. Pursuant to Section 15(b)(6) of the Exchange Act, respondents Agola, Boccio, Cunningham, Hoffman and Parisi be, and hereby are, suspended from association with any broker or dealer for a period of three (3) months, effective on the first Monday following the entry of this Order;

G. Pursuant to Section 15(b)(6) of the Exchange Act, respondents Purpora and Murphy are hereby suspended from association in a supervisory capacity with any broker or dealer for a period of three (3) months, effective on the first Monday following the entry of this Order;

H. Respondents Agola, Boccio, Cunningham, Parisi, Purpora, and Murphy each shall, within thirty (30) days of the entry of this Order, pay a civil money penalty in the amount of $100,000 to the United States Treasury, and Respondent Hoffman shall, within thirty (30) days of the entry of this Order, pay a civil money penalty in the amount of $50,000 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 them as Respondents in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Sanjay Wadhwa, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, Room 400, New York, NY 10281-1022.

I. Respondents Agola, Boccio, Cunningham, Hoffman, Parisi, Purpora, and Murphy each shall comply with the undertaking enumerated in paragraph 41 above.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 230

Release No. 33-9098; File No. S7-30-09

RIN 3235-AK29

REVISIONS TO RULE 163

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: We are proposing amendments to Rule 163(c) under the Securities Act of 1933 that would allow a well-known seasoned issuer to authorize an underwriter or dealer to act as its agent or representative in communicating about offerings of the issuer's securities prior to the filing of a registration statement. We believe that the proposed amendments should further facilitate capital formation by well-known seasoned issuers by removing certain impediments to issuer communications with broader groups of potential investors regarding offerings of securities.

DATES: Comments must be received on or before [insert date 30 days after publication in 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 S7-30-09 on the subject line; or

- Use the Federal Rulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

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

All submissions should refer to File Number S7-30-09. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Ted Yu, Special Counsel, Office of Chief Counsel, at (202) 551-3500, in the Division of Corporation Finance, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-4561.

SUPPLEMENTARY INFORMATION: We are proposing amendments to Rule 163(c)[1] under the Securities Act.[2]

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1 17 CFR 230.163(c).

2 15 U.S.C. 77a et seq.

Table of Contents

I. Background

In 2005, we adopted various modifications to the registration, communications and offering processes under the Securities Act.[3] As part of those modifications, we liberalized the communications rules for a new category of issuers, called "well-known seasoned issuers" ("WKSIs"), so they would not be unnecessarily constrained in their capital formation activities while retaining important investor rights and remedies under the Securities Act. A WKSI is an issuer that meets the registrant requirements of Form S-3 or Form F-3; has at least $700 million in worldwide market value of outstanding voting and non-voting common equity held by non-affiliates (or has issued, for cash, within the last three years at least $1 billion aggregate principal amount of non-convertible securities through primary offerings registered under the Securities Act); and is not an "ineligible issuer," as defined in our rules.[4] We permitted these issuers to benefit the most from the liberalization of our offering and communication rules because they have a reporting history under the Exchange Act[5] and are presumptively the most widely-followed issuers in the marketplace.[6]

We adopted Rule 163 under the Securities Act as part of our 2005 reforms.[7] Pursuant to Rule 163, WKSIs can engage in unrestricted oral and written offers[8] before a

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3 See Securities Offering Reform, Securities Act Release No. 8591 (Aug. 3, 2005) [70 FR 44721] ("Securities Offering Reform Adopting Release").

4 See Securities Act Rule 405 [17 CFR 230.405].

5 15 U.S.C. 78a et seq.

6 See Securities Offering Reform Adopting Release, supra note 3, at Section II.A.

7 17 CFR 230.163.

8 Securities Act Section 2(a)(3) [15 U.S.C. 77b(a)(3)] defines "offer" as any attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. The term

registration statement is filed without violating the "gun-jumping" provisions of the Securities Act.[9] Rule 163 exempts an offer made "by or on behalf of" a WKSI from the prohibition in Section 5(c) of the Securities Act[10] on offers to sell, offers for sale, or offers to buy an issuer's securities before the filing of a registration statement, so long as the conditions of the rule are met. Under the current rule, a communication is deemed to be "by or on behalf of" a WKSI if the issuer or agent or representative of the issuer, other than an offering participant who is an underwriter or dealer, authorizes or approves the communication before it is made.[11]

II. Purpose of the Proposed Amendments to Securities Act Rule 163(c)

Rule 163 was adopted with the purpose of liberalizing the communication rules for WKSIs so that they could engage in oral and written communications, subject to certain enumerated conditions, before the filing of a registration statement for the offered securities. We believed that this rule, along with other modifications to the registration and offering process under the Securities Act adopted at the same time, would encourage more issuers to conduct their offerings on a registered basis, thereby enhancing investor

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"offer" has been interpreted broadly and goes beyond the common law concept of an offer. See Diskin v. Lomasney & Co., 452 F.2d 871 (2d. Cir. 1971); SEC v. Cavanaugh, 1 F. Supp. 2d 337 (S.D.N.Y. 1998).

9 As we described in the Securities Offering Reform Adopting Release, the Securities Act restricts the types of offering communications that issuers or other parties subject to the Act's provisions (such as underwriters) may use during a registered public offering. The nature of the restrictions depends on the period during which the communications are to occur. Violations of these restrictions generally are referred to as "gun jumping." See Securities Offering Reform Adopting Release, supra note 3, at Section III.A.

10 15 U.S.C. 77e(c).

11 See Rule 163(c) [17 CFR 230.163(c)].

protection.[12] At the time we adopted the rule and the automatic shelf registration process,[13] we expected that a WKSI would usually have a shelf registration statement on file that it could use for any of its registered offerings – an expectation shared by some commenters.[14] Accordingly, we expected that it would be unusual for WKSIs to make offers prior to the filing of a registration statement in reliance on the Rule 163 exemption.[15] We have since learned, however, that many WKSIs have not filed automatic shelf registration statements or that the automatic shelf registration statements they have filed may not register all of the types of securities that they may want to offer.[16] If a WKSI wants to make offers before a registration statement is filed, it must rely on the

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12 See Securities Offering Reform Adopting Release, 70 FR at 44777 ("We hope that providing these automatic shelf issuers more flexibility for their registered offerings, coupled with the liberalized communications rules we are adopting, will encourage these issuers to raise their necessary capital through the registration process").

13 Under the automatic shelf registration process, eligible WKSIs can register unspecified amounts of different specified types of securities using Form S-3 or Form F-3 registration statements that are effective upon filing.

14 See letter from the Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law. http://www.sec.gov/rules/proposed/s73804/dljohnson021105.pdf.

15 See Securities Offering Reform Adopting Release, supra note 3, at Section III.D.2.b.ii.

16 According to the data analyzed by the staff in our Office of Economic Analysis, 50% of the 2,273 registrants that indicated that they were WKSIs as of the end of their 2006 or 2007 fiscal years have filed an automatic shelf registration statement on either Form S-3 or F-3. At the time we proposed the modifications to the registration, communication, and offering processes under the Securities Act, we recognized that some issuers may have concerns regarding possible market overhang effect and solicited comments on whether the automatic shelf registration procedure should be made mandatory in order to eliminate concerns over any such effect. See Securities Offering Reform, Release No. 33-8501 (Nov. 14, 2004) [69 FR 67392] ("Securities Offering Reform Proposing Release") at Section V.B.2. Commenters believed that use of the automatic shelf registration process should be optional. See, e.g., letter from the Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law. As we noted in the Securities Offering Reform Adopting Release, we did not mandate the use of the automatic shelf registration process by WKSIs so that issuers would have the flexibility to file a registration statement on any form for which they are eligible and, if they wished, delay the effective date of their registration statements. See Securities Offering Reform Adopting Release, supra note 3, at Section V.B.2.a.ii.

Rule 163 exemption, and many WKSIs do not have registration statements on file.[17] As noted above, the Rule 163 exemption is not available for communications made by an offering participant that is an underwriter or dealer.

Some methods used in capital raising transactions have highlighted certain impediments in Rule 163 to a WKSI's communications with broader groups of potential investors regarding offerings of the issuer's securities.[18] Specifically, WKSIs may want to assess the level of investor interest in their securities before filing a registration statement (or a post-effective amendment to an already-filed automatic shelf registration statement)[19] for the offered securities. Although Rule 163 currently allows these issuers to communicate directly with potential investors to determine their interest in purchasing securities without violating the "gun-jumping" provisions of the Securities Act, we understand that many of these issuers either do not have sufficient knowledge about

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17 If a WKSI had filed a registration statement covering the securities being offered, then it would not need the exemption because Securities Act Section 5(c)'s prohibitions on offers being made before a registration statement has been filed would no longer apply to the securities included in the registration statement.

18 See, e.g., Lynn Cowan, Follow-On Deals Take a Night Shift – Increasing Number of Companies Work After-Hours to Line Up Orders, Wall St. J., Apr. 27, 2009 ("In a trading environment that can still be volatile, bankers and companies don't want to follow the traditional practice of marketing a deal over several days and then gauging investor interest. Instead, they are reaching out to large institutional investors such as mutual funds to make sure there's sizable interest, swiftly building a book of orders after the closing bell, and pricing before the market reopens the next day."); Lynn Cowan, "Wall Crossings" Provide Fund-Raising Edge, Wall St. J., Dec. 29, 2008 ("In a wall crossing, institutional investors are lined up to buy substantial chunks of new stock ahead of a public sale. In order to participate in what is essentially a private placement, those investors sign a confidentiality agreement that lets them cross the wall and become insiders. In exchange for gaining access to inside information, they are barred from trading in the stock until the public end of the deal is done. They gain no price advantage for signing on early.").

19 Under Securities Act Rule 413(b), a WKSI can add new classes of securities or securities of an eligible subsidiary to an automatic shelf registration statement at any time before the sale of those securities. In order to add new classes of securities, an issuer must file a post-effective amendment, which will be immediately effective, to register an unspecified amount of the new class of securities.

potential investors to contact them directly or prefer not to contact investors directly out of concern that any such contact could itself constitute and reveal material, non-public information about the issuers' capital-raising plans without the opportunity to first obtain a confidentiality agreement. Consequently, these issuers wish to be able to engage underwriters or dealers to approach their broader base of institutional clients on the issuers' behalf to ascertain their clients' interest in investing in the issuers' securities before filing a registration statement.[20] Because Rule 163 does not permit an offering participant who is an underwriter or dealer to make communications, or to authorize or approve communications, as an agent or representative of a WKSI, a WKSI without a registration statement on file or without having particular classes of securities included in the registration statement cannot engage underwriters or dealers to have discussions with potential investors on its behalf. This reduces the benefits of our earlier reforms for issuers considering registered offerings and could lead such issuers to conduct unregistered offerings, with the resultant loss of the rights and remedies available under the Securities Act to investors in registered offerings.

To address this concern, we are proposing to amend the "by and on behalf of an issuer" definition in Rule 163(c) so that, under certain circumstances, underwriters or dealers can be agents or representatives of WKSIs under the rule.[21] By preventing underwriters or dealers from acting on behalf of issuers, the current definition may be

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20 We understand that underwriters or dealers generally do not reveal the identity of the issuer to potential investors before securing agreements to retain the confidentiality of the information until it is publicly disclosed or is no longer material, non-public information. See, e.g., Cowan, "Wall Crossings" Provide Fund-Raising Edge, supra note 18. See also the discussion in Section III below on the applicability of Regulation FD to communications made in reliance on Rule 163.

21 We are proposing to amend the "by or on behalf of" definition solely for purposes of Rule 163, which, by its terms, is available only to WKSIs.

causing unnecessary impediments to the ability of WKSIs to communicate with a broader group of potential investors regarding the possibility and terms of securities offerings by the issuers. If adopted, the proposed amendments will enable WKSIs to better gauge the level of interest in the market for an offering and explore possible terms for such an offering before filing a registration statement or including the securities in the registration statement through a post-effective amendment. Allowing authorized underwriters or dealers to be agents or representatives of a WKSI will provide these issuers with access to the underwriters' or dealers' existing networks of investors to assess market interest in the issuer's securities.

The proposed amendments would remove impediments from the ability of WKSIs to raise capital through registered offerings rather than through private offerings which, as we previously recognized, often require issuers to offer liquidity discounts to potential investors due to the corresponding resale restrictions imposed on the securities sold.[22] We also believe that investors would benefit from our existing regulatory framework of specific disclosure requirements that apply to registered offerings,[23] from greater liquidity for the acquired securities because they will not be acquired in private transactions with corresponding resale restrictions,[24] and from important rights and remedies under the Securities Act.[25] We believe the proposed amendments are consistent

22 See Securities Offering Reform Proposing Release, supra note 16, at Section XI.C.3.

23 See, e.g., Regulation S-K [17 CFR 229.10 et seq.].

24 We have previously recognized that securities sold pursuant to registration statements generally enjoy more liquid markets than unregistered securities. See, e.g., Securities Offering Reform Proposing Release, supra note 16, at Section XI.C.3.

25 While communications made pursuant to Rule 163 are exempt from the prohibitions of Securities

with our traditional recognition of the "broad remedial purposes" of the Securities Act and the underlying "public policy which strongly supports registration."[26]

III. Proposed Amendments to Securities Act Rule 163(c)

We are proposing to amend Rule 163(c) to provide that an underwriter or dealer could be an agent or representative of a WKSI under Rule 163 if the following conditions are satisfied:

- the underwriter or dealer receives written authorization from the WKSI to act as its agent or representative before making any communication on its behalf;[27]
- the issuer authorizes or approves any written or oral communication before it is made by an authorized underwriter or dealer as agent or representative of the issuer;[28] and

Act Section 5(c), they are still considered offers and, therefore, subject to liability provisions applicable to such offers. These provisions include Securities Act Section 12(a)(2) [15 U.S.C. 77l(a)(2)], Securities Act Section 17(a) [15 U.S.C. 77q(a)], Exchange Act Section 10(b) [15 U.S.C. 78j(b)], and Exchange Act Rule 10b-5. In addition, written communications made in reliance on Rule 163 must be filed as free writing prospectuses when the related registration statement is filed, and will be subject to liability as such.

26 See Notice of Adoption of Rules 145 and 153A, Prospective Rescission of Rule 133, Amendment of Form S-14 under the Securities Act of 1933, and Amendment of Rules 14a-2 and 14c-5 under the Securities Act of 1934, Securities Act Release No. 5316 (Oct. 6, 1972) [37 FR 23631]; Notice of Adoption of Rule 144 Relating to the Definition of the Terms "Underwriter" in Sections 4(1) and 2(11) and "Brokers' Transactions" in Section 4(4) of the Securities Act of 1933, Adoption of Form 144, and Rescission of Rules 154 and 155 under that Act, Securities Act Release No. 5223 (Jan. 11, 1972) [37 FR 591].

27 See proposed Rule 163(c)(1).

28 See proposed Rule 163(c)(2). One way that an issuer could satisfy this condition is to approve the contents of the information that will be conveyed by the authorized underwriter or dealer to potential investors through oral communications.

- any authorized underwriter or dealer that has made any authorized communication on behalf of the issuer in reliance on Rule 163 is identified in any prospectus contained in the registration statement that is filed for the offering to which the communication relates.[29]

All other provisions of Rule 163 would continue to apply, including that:

- all communications made by or on behalf of the issuer and in reliance on Rule 163 would continue to be subject to Regulation FD;[30]
- every written communication that is an offer made in reliance on the Rule 163 exemption would contain substantially the legend required by the rule;[31] and
- every written communication that is an offer made in reliance on the Rule 163 exemption would be filed with the Commission as a free writing prospectus when the registration statement, or amendment to the registration statement, is filed.[32]

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29 See proposed Rule 163(c)(3).

30 Rule 163(e) [17 CFR 230.163(e)]; Regulation FD [17 CFR 243.100 et seq.]. We note that the amendments we are proposing today do not affect any other provision of existing Rule 163, including the continued applicability of Regulation FD to communications made in reliance on the exemption. As discussed below, communications made in reliance on Rule 163 are not considered to be in connection with a registered securities offering for purposes of the exclusion from Regulation FD.

31 Rule 163(b)(1) [17 CFR 230.163(b)(1)]. Under the proposed amendments, issuers or their agents or representatives would continue to have the ability under Rule 163(b)(1) to "cure" a failure to include the required legend in any written communication made in reliance on the exemption.

32 As is currently the case, the filing condition of Rule 163(d) would apply only if and when a registration statement, or an amendment to the registration statement, is filed. Accordingly, if no such registration statement is filed, a free writing prospectus used pursuant to Rule 163 does not have to be filed. Issuers or their agents or representatives would continue to have the ability under Rule 163(b)(2) to "cure" a failure to meet the filing condition when making any written communication in reliance on the Rule 163 exemption.

We believe that the proposed expansion of Rule 163 to permit authorized underwriters and dealers to communicate on behalf of a WKSI would enable the issuer to communicate with a broader group of potential investors in a manner that would not adversely affect the market for the issuer's securities. This proposed expansion also would be in the interest of investors as it would allow underwriters or dealers acting on behalf of an issuer to communicate directly with investors. If an issuer decides to sell securities pursuant to a registration statement after its authorized underwriter or dealer determines that there is sufficient interest, investors would have the same rights and remedies as any other investor in a registered offering under the Securities Act.

Under the proposed amendments to Rule 163, the first condition is that the underwriter or dealer must receive written authorization from the issuer to act as its agent or representative before engaging in any communication on behalf of the issuer in reliance on the proposed amended rule.[33] The proposed amendments are for the limited purpose of enabling issuers to authorize underwriters or dealers to approach potential investors on their behalf regarding a possible offering of the issuers' securities.[34] We are not proposing to amend the rule to permit unrestricted communications by any market participant. We do not believe an underwriter or dealer should be able to rely upon Rule 163, without prior authorization from the issuer, to gauge interest in the market for an issuer's securities and then present the issuer with an unsolicited proposal for an offering

33 See proposed Rule 163(c)(1).

34 As we noted at the time we liberalized the communication regime for WKSIs, we believe that communications made by WKSIs have less potential for conditioning the market for the securities to be sold in a registered offering because of the market's familiarity with such large, more seasoned issuers and the ongoing market following of their activities. See Securities Offering Reform Adopting Release, supra note 3, at Section III.C.

of that class of securities. Such activities would go beyond the limited purpose of the proposed amendments to Rule 163. By requiring that the underwriter or dealer receive written authorization before making pre-filing offers on behalf of the issuer in reliance on Rule 163, the proposed amendments require that the issuer be involved with any communications made by the underwriters or dealers in reliance on Rule 163.[35]

The second condition of the proposed amended rule is that the issuer must authorize or approve any written or oral communication before it is made by an authorized underwriter or dealer.[36] Any written or oral communication made by an authorized underwriter or dealer under the proposed amended Rule 163(c) would be considered an issuer communication. Any written communication that is approved or authorized by the issuer and made pursuant to the proposed amended rule on behalf of the issuer would need to be filed as a free writing prospectus when a registration statement for the offering is filed.[37] An oral communication made by an authorized underwriter or dealer pursuant to the proposed amended rule would not be subject to a filing requirement.

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35 We note that the requirement for prior written authorization in proposed amended Rule 163(c) is not intended to limit or otherwise affect the existing ability of an underwriter or dealer that is not acting on behalf of an issuer from making "reverse inquiry" offers in registered offerings. Under the "reverse inquiry" process, which is commonly used in medium-term note programs, an investor may be allowed to purchase securities from the issuer through an underwriter or dealer that is not designated in the prospectus as the issuer's agent by having such underwriter approach the issuer with an interest from the investor. See Joseph McLaughlin and Charles J. Johnson, Jr., Corporate Finance and the Securities Laws (4th ed. 2006). If the reverse inquiry process is used in offerings for which the issuer has already filed a registration statement, the requirement in proposed Rule 163(c)(1) for prior written authorization should not affect reverse inquiry offers since Section 5(c) of the Securities Act permits offers to be made after the filing of a registration statement.

36 See proposed Rule 163(c)(2).

37 Rule 163(b)(2) [17 CFR 230.163(b)(2)].

The proposed rule amendment is not intended to permit communications authorized by persons other than the WKSI. Thus, while the proposed amended Rule 163(c) would permit underwriters and dealers to act as the issuer's agents or representatives for purposes of making a communication, they would not be permitted, in turn, to authorize or approve a communication to be made by another person.

We emphasize that the amendments that we are proposing today do not change the applicability of Regulation FD to communications made in reliance on Rule 163. As is the case today, communications made in reliance on the proposed amended rule would not be considered to be in connection with a registered securities offering for purposes of the exclusion from Regulation FD.[38] Therefore, WKSIs would need to continue to comply with the provisions of Regulation FD with regard to any communications made pursuant to proposed amended Rule 163 to which Regulation FD would apply (including pre-filing communications made on behalf of the issuer by an authorized underwriter or dealer). If an authorized underwriter or dealer acting on behalf of an issuer desires to communicate material non-public information[39] in reliance on proposed amended Rule 163 to persons enumerated in Regulation FD,[40] the issuer, or the underwriter or dealer acting on its behalf, would first need to obtain a confidentiality agreement from the

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38 Rule 163(e); Exchange Act Rule 100(b)(2)(iv) [17 CFR 243.100(b)(2)(iv)].

39 When we adopted Regulation FD, we recognized that, while not necessarily per se material, "events regarding the issuer's securities," such as "public or private sales of additional securities," were one of the types of information or events that should be reviewed carefully to determine whether they are material. See Selective Disclosure and Insider Trading, Release No. 33-7881 (Aug. 15, 2000) [65 FR 51716] ("Regulation FD Adopting Release") at Section II.B.2.

40 Rule 100(b)(1) [17 CFR 243.100(b)(1)]. Regulation FD provides that when an issuer, or person acting on its behalf, discloses material non-public information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may trade on the basis of the information), it must make public disclosure of that information. See Regulation FD Adopting Release, supra note 39, at Section I.

enumerated persons or the issuer would need to publicly disclose the information in the manner[41] and within the timeframe set forth in Regulation FD.[42] Moreover, any misuse of the information for trading by any person subject to a confidentiality agreement would be covered under either the "temporary insider" or the misappropriation theory of insider trading.[43]

The third condition in proposed amended Rule 163(c) is that an authorized underwriter or dealer who makes a communication on behalf of a WKSI in reliance on Rule 163 must be identified in the prospectus contained in the registration statement for the offering of the issuer's securities related to the communication.[44] This identification would provide investors with information to supplement disclosure about the plan of distribution of the WKSI's securities.[45]

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41 Under Regulation FD, the required public disclosure may be made by filing or furnishing a Form 8-K, or by another method or combination of methods that is reasonably designed to effect broad non-exclusionary distribution of the information to the public. See Exchange Act Rule 101(e) [17 CFR 243.101(e)].

42 The timing of the required public disclosure depends on whether the selective disclosure of material non-public information was intentional or non-intentional. For an intentional selective disclosure, the issuer must make public disclosure simultaneously; for a non-intentional disclosure, the issuer must make public disclosure promptly. See Exchange Act Rule 100(a) [17 CFR 243.100(a)].

43 See Regulation FD Adopting Release, supra note 39, at Section II.B.1.a.

44 See proposed Rule 163(c)(3).

45 See Item 508 of Regulation S-K [17 CFR 229.508] and Securities Act Rule 430B [17 CFR 230.430B]. Item 508 of Regulation S-K requires the identification of the underwriters through which the securities are offered and certain disclosures regarding the identified underwriters, such as the nature of any material relationships between the underwriters and the issuer as well as the nature and amount of underwriter compensation. Underwriters for securities offered pursuant to a registration statement are subject to Section 11 liability for untrue statements of material facts or omissions of material facts required to be included in a registration statement or necessary to make the statements in the registration statement not misleading at the time the registration statement became effective.

Request for Comment

- We are soliciting comment on all conditions of the proposed amendments to Rule 163(c).
- Should an underwriter or dealer be required to obtain written authorization from the issuer to act as its agent in order to make offers pursuant to proposed amended Rule 163(c)? If not, why?
- Should the issuer be required to authorize or approve any written or oral communications before it is made by an underwriter or dealer acting as its agent?
- Should any written communications made by such authorized underwriters or dealers be required to be filed as any other issuer free writing prospectus under Rule 163? If not, why?
- What effect, if any, would the proposed amendments to Rule 163 have on the timing of the subsequent registered offering and what effect would such timing have on the ability of other investors in the registered offering, such as those investors who may not be approached until after the registration statement has been filed, to evaluate the offering?
- To what extent would the proposed amendments to Rule 163 enable WKSIs to reach a broader group of investors and affect their ability to raise capital through registered offerings? Are there any other modifications that should be made to the conditions of Rule 163 that may facilitate the ability of WKSIs to raise capital with appropriate protections? What other effects, if any, would the proposed amendments

have on the ability of WKSIs to raise capital? Would the proposed amendments have any effect on the ability of issuers other than WKSIs to raise capital? Please explain in detail and provide supporting empirical data.

- What are the reasons that WKSIs may not have filed automatic shelf registration statements or included certain classes of securities on filed automatic shelf registration statements? How would the proposed amendments to Rule 163 affect an issuer's decision to file an automatic shelf registration statement? Please provide empirical data to the extent available.
- Should we limit the types of investors that an authorized underwriter or dealer could approach under proposed amended Rule 163, such as to qualified institutional buyers, as defined in Securities Act Rule 144A(a)(1),[46] or to other types of investors who may not need the protections afforded by the Securities Act's registration provisions?[47] If so, why?
- Should an underwriter or dealer that made any authorized communications on behalf of an issuer in reliance on the proposed amended Rule 163 be required to be identified in the prospectus contained in the registration statement that is filed for the offering related to the communications?

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46 17 CFR 230.144A(a)(1).

47 See The Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 6806 (Oct. 25, 1988) [53 FR 33147].

IV. General Request for Comments

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

- the proposed rule changes that are the subject of this release;
- additional or different changes; or
- other matters that may have an effect on the proposal contained in this release.

We request comment from the point of view of registrants, investors and other users of information who may be affected by the proposed rule changes. With respect to any comments, we note that they are of greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments.

V. Paperwork Reduction Act

A. Background

Our proposed amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 (PRA).[48] We are submitting these to the Office of Management and Budget (OMB) for review in accordance with the PRA.[49] The title for the information collection is "Rule 163 (17 CFR 230.163)(OMB Control No. 3235-0619)." An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a current valid control number. The information collection requirements related to proposed amendments to Rule 163(c) would apply only to WKSIs and authorized offering participants choosing to rely on the proposed amended rule. Specifically, any free writing prospectus used by a WKSI or by an authorized offering participant would have

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[48] 44 U.S.C. 3501 et seq.

[49] See 44 U.S.C. 3507 and 5 CFR 1320.11.

to be filed and be publicly available on the EDGAR system if and when the WKSI files a registration statement (or a post-effective amendment to an automatic shelf registration statement) to cover the securities offered pursuant to the proposed amended rule. Although WKSIs would not be required to engage offering participants to make authorized communications, if they did, the information collection requirement would be mandatory.

The estimates of reporting and cost burdens provided in this PRA analysis address the time, effort and financial resources necessary to provide the proposed collections of information and are not intended to represent the full economic cost of complying with the proposal.

B. Summary of Information Collections

The proposed amendments to Rule 163(c), if adopted, would revise the "by and on behalf of an issuer" definition used in the rule so that, under certain circumstances, underwriters or dealers could be agents or representatives of WKSIs and communicate on behalf of the issuers before a registration statement (or a post-effective amendment to an automatic shelf registration statement) covering the offered securities has been filed. The proposal could increase the number of free writing prospectuses filed pursuant to Rule 163 as a result of the WKSIs' new ability to engage underwriters or dealers to make communications, which, if written, would be free writing prospectuses, on their behalf.

One of the conditions of the proposed amendments to Rule 163(c) is the identification of any authorized underwriters or dealers that made communications in reliance on the rule in the prospectus contained in the registration statement (or post-effective amendment to an automatic shelf registration statement) filed for the offered securities. This proposed condition does not impose a new disclosure requirement because an authorized underwriter or dealer that made a communication on behalf of a WKSI in reliance on the proposed amended rule would generally be an underwriter or dealer for the offering related to that communication and would, therefore, already be required to be identified under Item 508 of Regulation S-K, regardless of the proposed condition.

C. Paperwork Reduction Act Burden Estimates

At the time we adopted Rule 163, we estimated that most WKSIs would have an automatic shelf registration statement on file and would therefore not rely on the exemption provided in the rule. Accordingly, we estimated that 53 free writing prospectuses would be filed under Rule 163 per year and that issuers would spend 13.25 hours per year on such filings.[50] We have since learned that many WKSIs have not filed automatic shelf registration statements; the staff estimates that only 50% of the 2,273 registrants that were WKSIs as of the end of their 2006 or 2007 fiscal years have filed an automatic shelf registration statement on either Form S-3 or F-3. Therefore, we believe it is appropriate to update our PRA estimates of the costs and burdens imposed by the collection of information requirements of the proposed amended Rule 163. For the free writing prospectus rules, as was the case when we proposed Rule 163,[51] we estimate that 25% of the burden of preparation is carried by the issuer internally and 75% of the burden is carried by outside professionals retained by the issuer at an average cost of $400 per

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[50] See Securities Offering Reform Proposing Release, supra note 16, at Section X.C.2. The calculation for the incremental burden hours issuers would spend under Rule 163 was 13.25 hours (53 free writing prospectuses filed, multiplied by 0.25 hours per filing).

[51] See Securities Offering Reform Proposing Release, supra note 16, at Section X.C.

hour. The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the issuer internally is reflected in hours.

The fact that many WKSIs do not have automatic shelf registration statements on file (or do not have the securities they propose to offer already included in their filed registration statements), along with our proposal to permit underwriters or dealers to make communications pursuant to Rule 163, may result in greater use of the Rule 163 exemption by issuers and potentially greater numbers of free writing prospectuses filed pursuant to the rule. However, since some communications made by underwriters or dealers in reliance on Rule 163 would be oral rather than written, and since an oral communication that is an offer need not be filed with the Commission as a free writing prospectus, the potential increase might be small. As a result of these two counteracting effects, we estimate for this analysis that the number of free writing prospectuses will double from our estimate at the time that Rule 163 was proposed. More specifically, we estimate that the incremental increase in the number of free writing prospectuses that may be filed pursuant to the proposed amended rule and number of incremental burden hours will be 53 free writing prospectuses and 13.25 hours per year, resulting in issuer personnel time of 3.3 hours and a cost of approximately $3,980 for the services of outside professionals. The following table illustrates the incremental annual compliance burden of the collection of information in hours and in cost for the proposed amendments to Rule 163:

	Incremental Annual Responses	Hours/Form	Incremental Burden	25% Issuer	75% Professional	$400 Prof. Cost
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.25	(E)=(C)*0.75	(F)=(E)*$400
Rule 163 filing	53	0.25	13.25	3.3	9.95	$3,980

D. Request for Comment

Pursuant to 44 U.S.C. § 3506(c)(2)(B), we request comments to (1) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information would have practical utility; (2) evaluate the accuracy of our estimate of the burden of the proposed collection of information; (3) determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; and (4) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

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 Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-30-09. Requests for materials submitted to OMB by the Commission with regard to the collection of information should be in writing, refer to File No. S7-30-09, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE, Washington, DC 20549. Because the OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, your comments are best assured of having their full effect if the OMB receives them within 30 days of publication.

VI. Cost Benefit Analysis

A. Background

We believe that the definition of "by or on behalf of an issuer" currently in Rule 163(c) may be causing unnecessary impediments to the ability of WKSIs to communicate with a broader group of potential investors about offerings of the issuers' securities by preventing underwriters or dealers from acting on behalf of such issuers. Further, the current definition may also be impeding potentially useful discourse with prospective investors regarding the possibility and terms of securities offerings by the issuers. Accordingly, we believe that it is appropriate to propose to amend the definition in Rule 163(c) so that, under certain circumstances, underwriters or dealers could be agents or representatives of WKSIs under Rule 163. We believe that the proposed amendments would enable WKSIs to better gauge the level of interest in the market for an offering and explore possible terms for such an offering before filing a registration statement (or a post-effective amendment to an already filed automatic shelf registration statement) covering the offered securities while retaining for investors important rights and remedies under the Securities Act.

B. Benefits

The purpose of the proposed amendments to Rule 163(c) is to allow authorized underwriters or dealers to communicate on behalf of WKSIs before a registration statement (or a post-effective amendment to an already filed automatic shelf registration statement) covering the offered securities has been filed. By removing impediments to the ability of WKSIs to communicate with a broader group of potential investors and access the capital markets through registered offerings, we believe that investors should benefit from our existing regulatory framework of specific disclosure requirements and remedies that apply in registered offerings and greater liquidity for the acquired securities because they will not be acquired in private transactions with corresponding resale restrictions. For WKSIs, the ability to engage offering participants who are underwriters or dealers for the purpose of communicating with a broader group of potential investors should allow greater access to capital through the use of the underwriters' or dealers' existing networks of investors and the increased flexibility in evaluating the possible terms of offerings.

The proposed amendments to Rule 163(c) would maintain the existing Securities Act liability scheme for communications made in reliance on the proposed amended rule and, because all communications made in reliance on proposed amended Rule 163 would be considered issuer communications regardless of whether they are made by an issuer or an authorized underwriter or dealer, the existing filing conditions in the rule would continue to apply to any written communications made in reliance on the rule. We believe that investor protection is further enhanced by removing certain impediments that WKSIs face in reaching a broader group of prospective investors in their capital raising activities through registered offerings rather than private offerings, while retaining for such investors important rights and remedies under the Securities Act, including available remedies under Securities Act Sections 11 and Section 12(a)(2).[52]

C. Costs

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[52] 15 U.S.C. 77k and 77l(a)(2).

The proposed amendments to Rule 163(c) may involve certain costs. To the extent that a communication made on behalf of a WKSI pursuant to the proposed amended rule is a written communication, it would be a free writing prospectus that the issuer would have to file as with any other written communication made in reliance on Rule 163. For purposes of the PRA, we estimate the incremental costs to be issuer personnel time of 3.3 hours and approximately $3,980 for the services of outside professionals. If the communications are made orally, however, there would be no significant incremental costs because such communications would not have to be transcribed and filed in written form.

Another cost that may arise from the proposed amendments to Rule 163(c) is a possible decrease in the number of automatic shelf registration statements filed by WKSIs prior to an offering. In adopting the rules for automatic shelf registration statements for WKSIs, we hoped to provide sufficient flexibility for WKSIs to encourage capital formation through the registration process. Expanding Rule 163(c) to allow WKSIs to engage underwriters and dealers to act as their agent or representative in communicating with a broader group of investors may result in WKSIs waiting to file automatic shelf registration statements until after they have gauged the market's interest in an immediate offering. This decision not to file a registration statement in advance of identifying the classes of securities to be sold may delay the dissemination to the market of certain information regarding the issuer and its plans, such as the possibility that the issuer is contemplating an immediate offering of those types of securities. We believe, however, that many WKSIs will still file automatic shelf registration statements, even if they have no plans for an immediate offering, to have the capacity to sell their registered securities on an immediate basis without having to wait for an automatic shelf registration statement to be filed.

To the extent that the proposed amended rule would encourage more WKSIs to file automatic shelf registration statements, these filings, as is the case today, would not be subject to review by the staff of the Division of Corporation Finance because they become effective automatically upon filing. Investors may lose the benefit of better disclosure prompted by staff review. These filers, however, would continue to be obligated to disclose, on an annual basis, written, unresolved staff comments on their periodic report disclosures that were issued more than 180 days prior to the fiscal year end covered by the report and that the issuer believes are material.

The proposed amendments to Rule 163 would enhance access to the capital markets for only WKSIs. As a result, it is possible that other issuers, smaller than WKSIs or ineligible to be WKSIs, may encounter a more competitive capital-raising environment if they attempt to solicit investments from the same class of potential investors as those targeted by the WKSIs.

As proposed, an issuer must authorize an underwriter or dealer in writing before the underwriter or dealer can make any communications pursuant to the proposed amended rule. Arranging for this authorization may result in additional costs for issuers and underwriters or dealers.

D. Request for Comment

We request comments on this cost-benefit analysis and any of the costs and benefits associated with the proposed amendments to Rule 163(c). We solicit quantitative data to assist with our assessment of the costs and benefits of the proposed rule amendments.

VII. Consideration of Promotion of Efficiency, Competition and Capital Formation

Securities Act Section 2(b)[53] requires us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. The proposed amendments to Rule 163(c) are intended to remove certain impediments to communications by or on behalf of WKSIs with a broader group of potential investors before filing a registration statement (or a post-effective amendment to an already-filed automatic shelf registration statement) covering the securities being offered. We anticipate the proposed rule amendments will enhance a WKSI's ability to identify and communicate with investors regarding potential investments with the issuer and, as a result, make the capital formation process more efficient for these issuers. WKSIs will benefit from their authorized underwriter's or dealer's existing networks of investors when assessing market interest in their securities offerings, thereby potentially increasing their access to capital and improving their ability to issue securities on favorable terms to the issuer.

The proposed amendments to Rule 163 would enhance access to the capital markets for only WKSIs. As a result, it is possible that other issuers may not have the same capital-raising efficiencies if they attempt to solicit investments from the same class of potential investors as those targeted by the WKSIs, potentially creating a competitive

53 15 U.S.C. 77b(b).

advantage for some WKSIs. As we discussed in the Securities Offering Reform Adopting Release, these potential effects are justified in order to ensure that investors have appropriate access to information about issuers of different sizes.[54]

We request comment on whether the proposed rule amendments, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data and other factual support for their views, if possible.

VIII. Regulatory Flexibility Act Certification

Section 3(a) of the Regulatory Flexibility Act[55] requires the Commission to undertake a Regulatory Flexibility Analysis of the effect of its rules on small entities unless the Commission certifies that the rules do not have a significant economic impact on a substantial number of small entities. Securities Act Rule 157[56] defines an issuer to be a "small business" or "small organization" for purposes of the Regulatory Flexibility Act if it had total assets of $5 million or less on the last day of its most recent fiscal year.

Pursuant to Section 605(b) of the Regulatory Flexibility Act,[57] the Commission hereby certifies that the proposed amendments to Rule 163(c), if adopted, will not have a significant economic impact on a substantial number of small entities. Rule 163 is, by its terms, available only to WKSIs. We believe that few, if any, small entities will be able to meet the $700 million non-affiliate equity market capitalization threshold[58] or the $1

54 See Securities Offering Reform Adopting Release, supra note 3, at Section X.

55 5 U.S.C. 603(a).

56 17 CFR 240.0-10(a).

57 5 U.S.C. 605(b).

58 To satisfy this threshold, the worldwide market value of the issuer's outstanding voting and non-voting common equity held by non-affiliates must be $700 million or more as of a date within 60

billion non-convertible securities issuance threshold[59] to be considered WKSIs. For this reason, the proposed rule amendments, if adopted, should not have a significant economic impact on a substantial number of small entities.

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

IX. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[60] a rule is "major" if it has resulted, or is likely to result, in:

- an annual effect on the U.S. economy of $100 million or more;
- a major increase in costs or prices for consumers or individual industries; or
- significant adverse effects on competition, investment, or innovation.

We request comment on whether the proposed amendments to Rule 163(c) would be a "major rule" for purposes of the Small Business Regulatory Enforcement Fairness Act. We solicit comment and empirical data on: (1) the potential effect on the U.S. economy on an annual basis; (2) any potential increase in costs or prices for consumers or individual industries; and (3) any potential effect on competition, investment, or innovation.

X. Statutory Authority – Text of the Proposed Amendments

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days of the determination date. See Securities Act Rule 405 [17 CFR 230.405]

59 To satisfy this threshold, the issuer must have issued for cash more than an aggregate of $1 billion in non-convertible securities, other than common equity, through registered primary offerings over the prior three years. See Securities Act Rule 405 [17 CFR 230.405].

60 5 U.S.C. 801 et seq.

We are proposing the amendments pursuant to Sections 7, 10, 19, and 28 of the Securities Act, as amended.

List of Subjects

17 CFR Part 230

Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, we are proposing to amend title 17, chapter II of the Code of Federal Regulations as follows:

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

1. The 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, 79t, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

2. Amend §230.163 by revising paragraph (c) to read as follows:

§230.163 Exemption from section 5(c) of the Act for certain communications by or on behalf of well-known seasoned issuers.

* * * * *

(c) For purposes of this section, a communication is made by or on behalf of an issuer if the issuer or an agent or representative of the issuer, other than an offering participant who is an underwriter or dealer, authorizes or approves the communication before it is made. Provided, however, an offering participant who is an underwriter or dealer may be an agent or representative of the issuer for purposes of this section if:

(1) the underwriter or dealer receives written authorization from the issuer to act as its agent or representative prior to making any communication in reliance on this exemption;

(2) the issuer authorizes or approves any written or oral communication before it is made by an underwriter or dealer authorized pursuant to the provision of this section to act as agent or representative of the issuer; and

(3) any underwriter or dealer authorized pursuant to the provision of this section that has made any communication authorized pursuant to the provision of this section is identified in the prospectus contained in the registration statement or amendment that may be filed for the offering of the issuer's securities related to the communication.

* * * * *

By the Commission.

Elizabeth M. Murphy
Secretary

Dated: December 18, 2009

Florence E Harmon

By: Florence E. Harmon
Deputy Secretary

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

Securities Act of 1933
Release No. 9099 / December 22, 2009

Securities Exchange Act of 1934
Release No. 61212 / December 22, 2009

ORDER APPROVING PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD BUDGET AND ANNUAL ACCOUNTING SUPPORT FEE FOR CALENDAR YEAR 2010

The Sarbanes-Oxley Act of 2002 (the "Act") established the Public Company Accounting Oversight Board ("PCAOB") to oversee the audits of public companies and related matters, to protect investors, and to further the public interest in the preparation of informative, accurate and independent audit reports. The PCAOB is to accomplish these goals through registration of public accounting firms and standard setting, inspection, and disciplinary programs. Section 109 of the Act provides that the PCAOB shall establish a reasonable annual accounting support fee, as may be necessary or appropriate to establish and maintain the PCAOB. Section 109(h) amends Section 13(b)(2) of the Securities Exchange Act of 1934 to require issuers to pay the allocable share of a reasonable annual accounting support fee or fees, determined in accordance with Section 109 of the Act. Under Section 109(f), the aggregate annual accounting support fee shall not exceed the PCAOB's aggregate "recoverable budget expenses," which may include operating, capital and accrued items. Section 109(b) of the Act directs the PCAOB to establish a budget for each fiscal year in accordance with the PCAOB's internal procedures, subject to approval by the Securities and Exchange Commission (the "Commission").

On July 18, 2006, the Commission amended its Rules of Practice related to its Informal and Other Procedures to add a rule to facilitate the Commission's review and approval of PCAOB budgets and accounting support fees.[1] This budget rule provides, among other things, a timetable for the preparation and submission of the PCAOB budget and for Commission actions related to each budget, a description of the information that should be included in each budget submission, limits on the PCAOB's ability to incur expenses and obligations except as provided in the approved budget, procedures relating to supplemental budget requests, requirements for the PCAOB to furnish on a quarterly basis certain budget-related information, and a list of definitions that apply to the rule and to general discussions of PCAOB budget matters.

In accordance with the budget rule, in March 2009 the PCAOB provided the Commission with a narrative description of its program issues and outlook for the 2010 budget year. In response, the Commission staff provided to the PCAOB staff economic assumptions and budgetary guidance for the 2010 budget year. The PCAOB subsequently delivered a preliminary budget and budget justification to the Commission. Staff from the Commission's Offices of the Chief Accountant and Executive Director dedicated a substantial amount of time to the review and analysis of the PCAOB's programs, projects and budget estimates; reviewed the PCAOB's estimates of 2009 actual spending; and attended several meetings with management and staff of the PCAOB to develop an understanding of the PCAOB's budget and operations. During the course of the Commission's review, the Commission staff relied upon representations and supporting documentation from the PCAOB. Based on this comprehensive review, the

[1] 17 CFR 202.11 See Release No. 33-8724 (July 18, 2006) [71 FR 41998 (July 24, 2006)].

Commission issued a "pass back" letter to the PCAOB. The PCAOB approved its 2010 budget on November 30, 2009 and submitted that budget for Commission approval.

After considering the above, the Commission did not identify any proposed disbursements in the 2010 budget adopted by the PCAOB that are not properly recoverable through the annual accounting support fee, and the Commission believes that the aggregate proposed 2010 annual accounting support fee does not exceed the PCAOB's aggregate recoverable budget expenses for 2010. The Commission looks forward to the PCAOB's annual updating of its strategic plan and the opportunity for the Commission to review and provide views to the PCAOB on a draft of the updated plan.

As part of its review of the 2010 PCAOB budget, the Commission notes that there are certain budget-related matters that should be addressed or more closely monitored during 2010. These matters relate to: (1) the PCAOB's inspections program; (2) its information technology programs; and (3) potential legislative actions that could impact the PCAOB. Because of the importance of each of these matters, the Commission deems it necessary to set forth the following specific measures.

Accordingly, with respect to the PCAOB's 2011 budget cycle, the PCAOB will:

(1) Continue to include in its quarterly reports to the Commission information about the PCAOB's inspections program. Such information will include (a) statistics relative to the numbers and types of firms budgeted and expected to be inspected in 2010, including by location and by year the inspections are required to be conducted in accordance with the Act and PCAOB rules, (b) information about the timing of the issuance of inspections reports for domestic and non-U.S. inspections, and (c) updates on the PCAOB's efforts to

establish cooperative arrangements with respective non-U.S. authorities for inspections required in those countries.

(2) Continue to include detailed information about the state of the PCAOB's information technology in its quarterly reports to the Commission, including planned, estimated, and actual costs for information technology projects, including the annual and special reporting system and the inspections information system.

(3) Consult with the Commission about the PCAOB's plans for implementing any changes in response to legislative actions.

The Commission has determined that the PCAOB's 2010 budget and annual accounting support fee are consistent with Section 109 of the Act. Accordingly,

IT IS ORDERED, pursuant to Section 109 of the Act, that the PCAOB budget and annual accounting support fee for calendar year 2010 are approved.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9100 / December 22, 2009

SECURITIES EXCHANGE ACT OF 1934
Release No. 61213 / December 22, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13728

In the Matter of **APPLIED MINERALS, INC. (FORMERLY KNOWN AS ATLAS MINING COMPANY),** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Applied Minerals, Inc., formerly known as Atlas Mining Company ("Atlas Mining" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

SUMMARY

These proceedings arise from repeated registration violations, internal control deficiencies, and inaccurate and untimely financial filings by Atlas Mining, a publicly-traded mining company. Specifically, from 2002 through late 2005, Atlas Mining improperly issued millions of shares of its common stock that purportedly had been registered with the Commission on Forms S-8 and/or SB-2. This misconduct allowed stock promoters and Atlas Mining to reap illicit profits by reselling Atlas Mining stock to investors who had been denied legally mandated disclosures. In late 2007, Atlas Mining announced its intention to restate its financial statements for the periods 2004 through 2006 when these improper stock issuances and other potential issues came to light. When Atlas Mining filed its restated financial statements in the Summer of 2009, it reported the correction of numerous errors in its past filings, including errors related to its improper S-8 and SB-2 stock issuances, and acknowledged longstanding material weaknesses in its internal controls, including the lack of effective oversight and monitoring of the financial reporting and accounting functions at the company.

RESPONDENT

1. **Applied Minerals, Inc. (formerly known as Atlas Mining Company)** is a mining company incorporated in Delaware and currently headquartered in New York, New York. At all relevant times, Atlas Mining was incorporated in Idaho and headquartered in Osburn, Idaho. Atlas Mining's common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and is quoted on the OTC Bulletin Board under the ticker symbol ALMI.

OTHER RELEVANT PERSON

2. **William Jacobson**, age 62, resides in Missoula, Montana. Jacobson was Chairman, CEO and President of Atlas Mining from August 1997 to July 2007; Chairman from July 7, 2007 to November 30, 2007; and, Chairman, interim CEO and President from November 30, 2007 to June 27, 2008. On June 27, 2008, Jacobson resigned from Atlas Mining in connection with an internal investigation initiated by the company.

BACKGROUND

3. Atlas Mining is a mining company that employed between five and sixty-five people during the relevant time period. Incorporated in 1924, Atlas Mining was inactive from 1980 to the Fall of 1997 when it restarted mining operations.

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

4. Atlas Mining's stock began trading on the OTC Bulletin Board on July 19, 2002. From 2002 to 2004, the stock price ranged from $0.05 to $0.40 per share. From 2005 through 2007, the stock price ranged from $0.38 to $2.98 per share.

5. Atlas Mining experienced annual operating losses from the time it resumed operations in September 1997 through at least 2007. Since at least April 2003, its auditors have repeatedly expressed uncertainty about the company's ability to operate as a going concern.

IMPROPER OFFER AND SALE OF FORM S-8 SECURITIES

6. Atlas Mining filed a Form S-8 registration statement on August 27, 2002. The Form S-8 was amended on July 8, 2003, and again on September 25, 2004. The registration statement and amendments attached and incorporated Atlas Mining's 2002 Consultant Stock Plan, which provided that shares were to be issued only to "consultants" of the company for bona fide consulting services. After filing the registration statement and amendments, Atlas Mining issued millions of shares of common stock.

7. 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 are natural persons who 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.

8. Between 2002 and late 2005, Atlas Mining issued approximately 16 million shares of its common stock under its registration statements on Form S-8. As described below, however, approximately 14.6 million or roughly 90% of these shares were issued to individuals and entities that were ineligible to receive shares registered on Form S-8.

9. In addition, Atlas Mining issued shares of S-8 stock to individuals who had provided no bona fide services to the company, including members of Jacobson's family. For example, 250,000 shares of Atlas Mining S-8 stock were issued to Jacobson's homemaker wife, and 500,000 shares were issued to Jacobson's son. Neither Jacobson's wife nor his son performed any bona fide services for Atlas Mining, and were therefore not eligible to receive S-8 shares.

10. Atlas Mining also issued millions of shares of S-8 stock directly to entities in violation of the requirement that S-8 shares be issued only to natural persons. For example, S-8 stock was issued directly to an affiliated mining company that had no operating mines and employed no miners at the time the stock was issued.

11. Atlas Mining further issued millions of shares of S-8 stock to stock promoters who were ineligible to receive S-8 shares.

12. Atlas Mining also issued shares of its S-8 stock to compensate consultants who provided capital-raising services to the company, and were therefore, ineligible to receive S-8 shares. Specifically, Atlas Mining issued S-8 shares to consultants who were raising funds for

Atlas Mining through private equity transactions, including a transaction where a consultant attempted to raise $1 million in a private investment in public equity or "PIPE" transaction involving Atlas Mining stock.

13. Atlas Mining's improper issuances of S-8 shares circumvented the federal securities laws and enabled stock promoters, financiers, and Jacobson to resell Atlas Mining stock to unknowing investors without the required disclosures about the company and the offerings.

IMPROPER OFFER AND SALE OF SHARES ISSUED ON FORM SB-2

14. In 2003 and 2004, Atlas Mining improperly issued nearly 10 million shares of Atlas Mining stock that were purportedly registered pursuant to Form SB-2, an abbreviated registration statement for small business issuers which requires disclosure of certain company information and information about the securities offering.

15. In early 2003, Atlas Mining registered for sale with the Commission 10 million shares of common stock at a fixed price of $0.10 per share. The registration statement, filed on Form SB-2, and prospectus represented that Atlas Mining was acting as a self-underwriter, and that the shares would be "sold directly by the company." The documents also represented that the registered offering would only remain open for 180 days, after which the offering would automatically expire.

16. To avoid expiration of the time-limited offering and the loss of the ability to sell the shares, Atlas Mining "parked" the unsold shares with related parties and affiliates. In total, 9.9 of the 10 million unsold shares were "parked" – 500,000 shares in March 2003, one million shares in July 2003, and the remaining 8.4 million shares on a single day at the end of the offering in August 2003.

17. The shares were "parked" through the issuance of share certificates in the names of nine related parties and affiliates. These sham purchasers included, among others, Jacobson's children, a subsidiary entity controlled by Atlas Mining management, and the teenage daughter of Jacobson's assistant who provided occasional janitorial services to the company. The individuals and entities in whose names the share certificates were issued did not pay for or actually take possession of the shares. Instead, the share certificates were sent directly to Atlas Mining, and were concealed in the company's files with the intent to resell the shares to bona fide investors after the expiration of the 180 day offering deadline in violation of the registration statement.

18. The "parking" transactions did not conform to the terms of the registration statement because the purported recipients never actually paid for or received the shares. Thus, the "parking" transactions were unregistered issuances.

19. From the Fall of 2003 through May of 2004, the 9.9 million "parked" shares of Atlas Mining common stock were resold to third parties in additional unregistered offerings. To complete the sales, the certificates to the sham recipients were returned to the transfer agent to be cancelled, and the shares were then transferred to the actual purchasers. The individuals and entities whose certificates were cancelled received no compensation for the shares; instead, all

purchase proceeds went directly to Atlas Mining (and certain affiliated entities). It was only after such resales that Atlas Mining and its affiliated entities ultimately received payments totaling $805,000 for the parked shares.

20. No registration statement was filed for the subsequent resale transactions, and no further amendment was made to the SB-2 registration statement or prospectus. Thus, the resale transactions were additional unregistered issuances.

21. Atlas Mining's unlawful parking and resale scheme enabled the company to raise financing without providing investors with the timely and accurate disclosures required by the federal securities laws.

FAILURE TO FILE TIMELY AND ACCURATE PERIODIC REPORTS

22. On October 9, 2007, Atlas Mining filed a Form 8-K announcing that it intended to restate its financial statements for 2004, 2005 and 2006 that it had previously filed with the Commission on Forms 10-Q and Forms 10-K. On January 17, 2008, Atlas Mining filed a Form 8-K announcing the appointment of two new directors and the initiation of a special committee internal investigation.

23. On August 27, 2008, Atlas Mining filed a Form 8-K summarizing the results of the Special Committee's investigation. In the Form 8-K, Atlas Mining announced that its financial statements filed with the Commission on Forms 10-Q and Forms 10-K for all periods beginning in 2002 through the second quarter of 2007 could not be relied upon due to numerous violations of the federal securities laws uncovered during the Special Committee's investigation.

24. From its October 9, 2007 announcement to July 15, 2009, Atlas Mining failed to file any annual and quarterly reports, beginning with its quarterly report on Form 10-Q for the third quarter of 2007.

25. On July 15, 2009, Atlas Mining filed restated financial results with the Commission for the first and second quarters of 2007. Atlas Mining also filed its delinquent quarterly report on Form 10-Q for the third quarter of 2007 and its delinquent annual report on Form 10-K for the fiscal year ended December 31, 2007. In its Form 10-K for fiscal year 2007, Atlas Mining restated its 2006 consolidated financial statements and corrected various items, including errors in the valuation of stock issued under Atlas Mining's S-8 plan and realized and unrealized gains and losses on available for sale securities, which related, in part, to the improper issuances of Atlas Mining securities registered on Form SB-2 described above.

26. By August 14, 2009, Atlas Mining had filed with the Commission its delinquent quarterly reports for the first, second and third quarters of 2008, its delinquent annual report for the fiscal year ended December 31, 2008, and its delinquent quarterly report for the first quarter of 2009.

INADEQUATE INTERNAL CONTROLS

27. From its reactivation of operations in the Fall of 1997 to August 8, 2007, Atlas Mining had no Chief Financial Officer. During this time, Jacobson served as the chief accounting officer for Atlas Mining, in addition to serving as Chairman, CEO and President. Accordingly, there was a lack of segregation of duties for the financial reporting process and a lack of effective oversight and monitoring of the financial reporting and accounting functions.

28. In addition, through the end of 2007, Atlas Mining lacked an effective period-end financial statement closing process. Specifically, Atlas Mining did not maintain a checklist of procedures or any formal guidance to facilitate the period-end closing process. Accordingly, there was a lack of controls over the period-end financial statement closing process.

29. Lastly, Atlas Mining reported in its Form 10-K for the period ended December 31, 2007, which was filed on July 15, 2009, that the company had identified material weaknesses in its disclosure internal controls, including ineffective oversight of related party transactions, revenue recognition, stock issued for services, stock issuances under option plans that were in violation of the terms of the plans, accounting for options, lack of appropriate accounting procedures and personnel, journal entry approval and procedures, and management's assessment of internal control over financial reporting.

ATLAS MINING COMPANY'S REMEDIAL EFFORTS

30. After Atlas Mining's violations came to light in late 2007, Atlas Mining promptly undertook significant remedial efforts. These efforts included undertaking an internal investigation; replacing all members of the management team of the company, including hiring a new CEO and CFO; changing all members of the Board of Directors; changing its independent auditor; adopting a Code of Conduct and Ethics for its CEO and senior financial officers; implementing internal control and corporate governance policies; and implementing additional remedial measures to improve its financial reporting and disclosure controls, including the appointment of a financial expert to the Board of Directors. Lastly, as of August 14, 2009, Atlas Mining brought itself current on all due and/or delinquent periodic reports.

VIOLATIONS

Respondent Violated Sections 5(a) and 5(c) of the Securities Act

31. As a result of the conduct described above, Atlas Mining 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.

Respondent Violated 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

32. As a result of the conduct described above, Atlas Mining violated 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 by filing inaccurate periodic reports with the Commission, by failing to make and keep accurate books and records, and by failing to devise and maintain an adequate system of accounting controls.

IV.

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

Accordingly, it is hereby ORDERED that:

Pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Respondent cease and desist from committing or causing any violations and any future violations of Sections 5(a) and 5(c) of the Securities Act, and 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.

By the Commission.

Elizabeth M. Murphy
Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 61234 / December 23, 2009

Admin. Proc. File No. 3-12653

In the Matter of

CHRIS G. GUNDERSON, ESQ.

OPINION OF THE COMMISSION

RULE 102(e) PROCEEDING

Grounds for Remedial Action

Violations of Registration and Antifraud Provisions

Attorney was permanently enjoined from violating registration and antifraud provisions of the federal securities laws. *Held*, it is in the public interest to permanently disqualify him from appearing or practicing before the Commission.

APPEARANCES:

Lawrence A. Garvey, of Cushner & Garvey, L.L.P., for Chris G. Gunderson.

Thomas Karr and *Karen Shimp*, for the Office of General Counsel.

Appeal filed: January 18, 2008
Last brief filed: September 2, 2008

I.

Chris G. Gunderson, an attorney, appeals from an administrative law judge's decision. The law judge determined that Gunderson should be permanently disqualified from appearing or practicing before the Commission, pursuant to Rule of Practice 102(e),[1] based on a permanent injunction entered against him for registration and antifraud violations of the federal securities laws. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

II.

Gunderson has been an attorney licensed to practice law in the State of New York for more than forty years. From 1995 until approximately September 2007, Gunderson served as general counsel for Universal Express, Inc. ("Universal Express" or the "Company"), a Nevada corporation.

On February 21, 2007, in a civil action brought by the Commission, the United States District Court for the Southern District of New York issued an opinion and order[2] finding that Gunderson (and others) issued and distributed unregistered Universal Express shares, in violation of Section 5 of the Securities Act of 1933,[3] and created and disseminated materially misleading press releases concerning Universal Express's business operations, in violation of Securities Act Section 17(a)[4] and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.[5]

Between April 2001 and January 2004, the district court found that Universal Express issued more than 500 million unregistered shares to four individuals under written agreements, drafted by Gunderson, exchanging stock purportedly for consulting services. During this time,

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[1] 17 C.F.R. § 201.102(e). Rule of Practice 102(e) was codified in Section 4C of the Securities Exchange Act of 1934, 15 U.S.C. § 78d-3, in accordance with the Sarbanes-Oxley Act of 2002.

[2] *SEC v. Universal Express, Inc.*, 475 F. Supp. 2d 412 (S.D.N.Y. 2007), *aff'd sub nom. SEC v. Altomare*, 300 Fed. Appx. 70 (2d Cir. 2008) (per curiam) (unpublished), *cert. denied,* 129 S. Ct. 2745 (2009).

[3] 15 U.S.C. § 77e.

[4] 15 U.S.C. § 77q(a).

[5] 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

Universal Express did not file any securities registration statements, except for two Forms S-8[6] supposedly registering a total of 50 million shares. There was no evidence that any shares were issued under the Forms S-8.

Of the more than 500 million unregistered shares, nearly 271 million shares were issued to one "consultant" pursuant to letters, drafted by Gunderson, that falsely informed Universal Express's transfer agent that the shares were "to be free trading under an S-8 registration [statement]."[7] Another approximately 231 million shares were issued to three other "consultants" pursuant to similar letters containing the "S-8 registration" phrase.

Several months after the last issuance of Universal Express stock based on a letter mentioning an "S-8 registration," Commission staff advised Universal Express's transfer agent that she might be charged with participating in the issuance of unregistered securities. The transfer agent informed Gunderson of the staff's communication and questioned him about the legality of the issuance of the shares. In response, Gunderson wrote to the transfer agent stating that the shares were properly registered pursuant to, and in compliance with, Universal Express's stock option plan, but they were not. The stock option plan only authorized the issuance of up to 104,167 shares due to a 1997 reverse stock split, far short of the more than 500 million shares that Gunderson stated were registered pursuant to the plan. The district court was unable to find any evidence that the 500 million unregistered shares were issued pursuant to either the Forms S-8 or stock option plan, leading it to conclude that, during the relevant period, Universal Express was not exempt from having to register the subject shares.

The district court also found that Gunderson engaged in a scheme to defraud investors when Universal Express issued a series of materially misleading press releases that Gunderson drafted or edited and then reviewed and approved. The press releases concerned the Company's financing, expansion, or other business operations, and contained statements that were "at best misleading and sometimes wholly fantastical."[8] Each press release was immediately followed by increases in Universal Express's share price and trading volume, permitting several of the defendants in the case to dispose of large amounts of the unregistered shares.

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6 Form S-8 "provides an abbreviated registration procedure for securities offered or sold to an issuer's employees, including consultants, under certain conditions." 475 F. Supp. 2d at 416 n.2. Form S-8 permits an issuer to issue stock to consultants or advisors only if they provide bona fide services to the issuer, the services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the issuer's securities. *See* http://www.sec.gov/about/forms/forms-8.pdf. (General Instruction A.1(a) to Form S-8).

7 *Universal Express,* 475 F. Supp. 2d at 417.

8 *Id.* at 426.

The district court rejected Gunderson's claims that, as general counsel for Universal Express, he acted in good faith. With respect to his liability under Securities Act Section 5 for issuing unregistered shares, the district court found that any claim of good faith was irrelevant because proof of scienter was not required to establish a violation of that provision. With respect to his liability under Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5 for disseminating materially misleading press releases, the district court found that Gunderson did not "identify any basis in truth that [he] discovered or relied on" in the course of verifying the press releases that would demonstrate his reasonable belief in the truth of the statements contained in the releases.[9] Gunderson also failed to show that a "reasonable investor" would share his own subjective understanding of certain words used in the press releases.

The district court granted the Commission's request for a permanent injunction against Gunderson from violating Securities Act Sections 5 and 17(a) and Exchange Act Section 10(b) and Exchange Act Rule 10b-5. The district court found it "clear" that Gunderson violated the federal securities laws' registration and antifraud provisions, and "if not enjoined, likely would do so again."[10] The district court found that Gunderson committed these violations "deliberately or at least recklessly and on repeated occasions"; he "not only den[ied] culpability but [did] so with incredible and contorted arguments"; and, as general counsel to Universal Express, he "remain[ed] in a position to commit possible [federal securities law] violations in the future."[11]

In addition, the district court ordered that Gunderson be barred from engaging in future offers of penny stock, stating, in relevant part:

> Although [Gunderson] did not directly solicit assistance with fraud and was not personally quoted in the materially misleading press releases, as general counsel of Universal Express he also occupied a position of significant power at the time of the violations and . . . repeatedly approved and contributed to acts of fraud and noncompliance with investor-protecting registration requirements. His apparent disregard for the law, evinced both by the repeated nature of his illegal conduct and his joining . . . in the meritless summary judgment motion is particularly egregious given his position as the chief lawyer for a publicly held company. For these reasons, there is much cause to expect future misconduct by Gunderson . . . .[12]

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9 *Id.* at 427.

10 *Id.* at 428.

11 *Id.*

12 *Id.* at 430.

The district court further ordered Gunderson to pay a total of $794,711, consisting of $361,317 in disgorgement, $72,077 in prejudgment interest, and $361,317 in third-tier civil money penalties.

On April 2, 2007, the district court entered its final judgment incorporating the permanent injunction, penny stock bar, and other relief against Gunderson. Gunderson appealed the district court's final judgment to the United States Court of Appeals for the Second Circuit.

On June 6, 2007, while Gunderson's Second Circuit appeal was pending, we instituted this administrative proceeding against Gunderson pursuant to Rule of Practice 102(e)(3)(i)[13] and temporarily suspended him from appearing or practicing before the Commission. Gunderson filed a timely petition to lift the temporary suspension,[14] which the Office of General Counsel ("OGC") opposed. The Commission denied Gunderson's petition and directed that a hearing be held before a law judge.[15]

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13 17 C.F.R. § 201.102(e)(3)(i). Rule of Practice 102(e)(3)(i) states:

(i) The Commission, with due regard to the public interest and without preliminary hearing, may, by order, temporarily suspend from appearing or practicing before it any attorney, accountant, engineer, or other professional or expert who has been by name:

(A) [p]ermanently 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; or

(B) [f]ound by any court of competent jurisdiction in an action brought by the Commission to which he or she is a party or found by the Commission in any administrative proceeding to which he or she is a party to have violated (unless the violation was found not to have been willful) or aided and abetted the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

14 *See* 17 C.F.R. § 201.102(e)(3)(ii) (stating, in pertinent part, that "[a]ny person temporarily suspended from appearing and practicing before the Commission in accordance with [Rule 102(e)(3)(i)] may, within 30 days after service upon him or her of the order of temporary suspension, petition the Commission to lift the temporary suspension").

15 *See* 17 C.F.R. § 201.102(e)(3)(iii) (stating, in pertinent part, that "[w]ithin 30 days after the filing of a petition in accordance with [Rule 102(e)(3)(ii)], the Commission shall either lift the temporary suspension, or set the matter down for hearing at a time and place designated by the Commission, or both, and, after opportunity for hearing, may censure the petitioner or disqualify the petitioner from appearing or practicing before the Commission for a period of time or permanently").

In the meantime, on June 29, 2007, the Commission moved the district court for an order holding Gunderson in civil contempt, alleging, among other things, that Gunderson defied the permanent injunction and penny stock bar by facilitating Universal Express's issuance of nearly 21 billion additional unregistered shares during the first half of 2007.

On August 31, 2007, the district court issued an opinion and order[16] finding the evidence to be "overwhelming" that Universal Express issued billions more unregistered shares with the "central and necessary involvement of" Gunderson.[17] The district court found that "[t]he substantial increase in the issuance of unregistered securities, combined with the specious justifications . . . [,] demonstrate[d] . . . active and willful disobedience of court orders."[18] Although the district court found that the record "would amply support" an immediate finding of civil contempt, it gave Gunderson "one last opportunity to comply" with its orders or rebut the Commission's "strong case" for a finding of contempt, and set the matter for a hearing.[19] At an October 12, 2007, hearing, the district court found that the need to hold Gunderson in contempt was largely mooted by its appointment of a receiver over Universal Express, thereby making it impossible for Gunderson to continue his violations.[20]

On December 20, 2007, the law judge, acting on OGC's motion for summary disposition pursuant to Rule of Practice 250(a),[21] concluded that it was in the public interest and necessary to preserve the integrity of the Commission's processes to permanently disqualify Gunderson from appearing or practicing before the Commission.

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16 *SEC v. Universal Express, Inc.*, No. 04 Civ. 2322 (GEL) (S.D.N.Y. Aug. 31, 2007), 2007 WL 2469452.

17 2007 WL 2469452, at *4.

18 *Id.* at *5

19 *Id.* at *11.

20 At a subsequent hearing on February 4, 2008, the Commission withdrew its remaining grounds for holding Gunderson in civil contempt based on his inability to pay the financial portion of the district court's final judgment.

21 17 C.F.R. § 201.250(a). At a prehearing conference, the parties agreed that the case was appropriate for summary disposition.

On November 13, 2008, during the pendency of this appeal, the Second Circuit affirmed the final judgment of the district court, stating that it did so "[s]ubstantially for the reasons stated in the district court's thorough and thoughtful opinion and order."[22]

III.

Rule of Practice 102(e) has been the primary tool available to the Commission to preserve the integrity of its processes and ensure the competence of the professionals, including attorneys, who appear and practice before it.[23] The Commission adopted the rule as a "means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence."[24] The rule generally enables the Commission to initiate administrative disciplinary proceedings against professionals who lack integrity or competence, engage in improper professional conduct, or who are found to have violated the federal securities laws.[25] The sanctions available in such proceedings include a censure, temporary suspension, and permanent disqualification from practice before the Commission.[26]

In this proceeding, the Commission has the burden to show that the petitioner has been permanently enjoined by a court of competent jurisdiction, by reason of his misconduct in an

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22 *SEC v. Altomare*, 300 Fed. Appx. 70, 71 (2d Cir. 2008) (per curiam) (unpublished), *aff'g* 475 F. Supp. 2d 412 (S.D.N.Y. 2007).

23 *Implementation of Standards of Professional Conduct for Attorneys*, Securities Exchange Act Rel. No. 46868 (Nov. 21, 2002) (proposed rule), 78 SEC Docket 3240, 3241; *see, e.g., Marrie v. SEC*, 374 F.3d 1196, 1200 (D.C. Cir. 2004) (stating that Rule of Practice 102(e) "is directed at protecting the integrity of the Commission's processes, as well as the confidence of the investing public in the integrity of the financial reporting process"); *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 (2d Cir. 1979) (stating that Rule of Practice 2(e), the predecessor to Rule of Practice 102(e), "represents an attempt by the Commission to protect the integrity of its own processes"; upholding the validity of Rule of Practice 2(e) as "reasonably related" to the purposes of the federal securities laws).

24 *Touche Ross*, 609 F.2d at 582.

25 *See* 17 C.F.R. § 201.102(e)(1)(i)-(iii).

26 *See* 17 C.F.R. §§ 201.102(e)(1), 201.102(e)(3)(iii). According to Rule of Practice 102(f), "practicing before the Commission" includes, but is not be limited to, "[t]ransacting any business with the Commission," and "[t]he preparation of any statement, opinion or other paper by any attorney, accountant, engineer or other professional or expert, filed with the Commission in any registration statement, notification, application, report or other document with the consent of such attorney, accountant, engineer or other professional or expert." 17 C.F.R. § 201.102(f).

action brought by the Commission, from violating or aiding and abetting the violation of the federal securities laws, or has been found by a court of competent jurisdiction to have violated or aided and abetted the violation of the federal securities laws.[27] Once that burden has been met, the burden shifts to the petitioner to show cause why he should not be censured or temporarily or permanently disqualified from appearing and practicing before the Commission.[28] However, the petitioner may not contest any finding made against him, or any fact admitted by him, in the underlying judicial proceeding.[29]

Here, OGC satisfied its burden by showing that the district court, a court of competent jurisdiction, in an action brought by the Commission, found Gunderson in violation of the federal securities laws' registration and antifraud provisions and, based on its findings, permanently enjoined him from violating those provisions. The sole issue therefore is whether Gunderson has shown cause, and if he has not, to determine the appropriate remedial sanction.

Gunderson seeks to show cause by arguing that due process prohibits us from taking any disciplinary action in this administrative proceeding until the Second Circuit has ruled on his appeal. However, "[i]t is well established that the existence of an appeal of the district court's decision does not affect the [permanent] injunction's status as a basis for administrative action."[30] As we have previously stated, "Unless and until it is vacated, the [permanent] injunction entered against [the respondent] is a valid basis for administrative action."[31] Gunderson's argument that "[i]t would be an egregious denial of [his] [constitutional] due process rights for the SEC to disqualify [him] from practicing or appearing before the Commission until . . . the completion of the appeals process" therefore lacks merit.[32] Moreover, as previously discussed, during the pendency of this administrative proceeding, the Second Circuit ruled on Gunderson's appeal and affirmed the district court's final judgment in its entirety.

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27 17 C.F.R. § 201.102(e)(3)(iv).

28 *Id.*

29 *See id.*

30 *Conrad P. Seghers*, Investment Advisers Act Rel. No. 2656 (Sept. 26, 2007), 91 SEC Docket 2293, 2297 & n.12 (citing cases), *petition denied,* 548 F.3d 129 (D.C. Cir. 2008).

31 *Id.* (quoting *Michael T. Studer,* 57 S.E.C. 890, 896-97 (2004)).

32 *Cf. Seghers v. SEC,* 548 F.3d 129, 136-37 (D.C. Cir. 2008) (holding that the Commission did not deny petitioner due process by not staying follow-on administrative proceeding during pendency of his appeal from district court's judgment, entered on jury verdict, enjoining him from future securities fraud).

Gunderson also argues that the law judge erred in excluding as irrelevant two exhibits that he submitted in support of his response to OGC's motion for summary disposition. Exhibit "A" was a collection of articles discussing "naked" short selling.[33] Exhibit "B" was a sample of press releases on "naked" short selling issued by Universal Express's president and Gunderson. According to Gunderson, the two exhibits were submitted "to illustrate and further support his contention that he acted in good faith and with the best interests of [Universal Express] in mind," and therefore "could not have had the scienter necessary to find him liable for" any violations.

By submitting these exhibits, it appears that Gunderson is seeking essentially to relitigate his alleged "good faith" in engaging in the issuance of unregistered securities and dissemination of materially misleading press releases. The district court rejected Gunderson's "good faith" claims, finding that he acted "deliberately or at least recklessly" in committing the violations. As noted, under Rule of Practice 102(e)(3)(iv), Gunderson may not contest, in this administrative proceeding, the findings made against him by the district court in the federal injunctive action. Consequently, we agree with the law judge that the exhibits were irrelevant to the proceeding.

IV.

OGC requests that we permanently disqualify Gunderson from appearing or practicing before the Commission. In determining the appropriate remedial sanction under Rule of Practice 102(e), we are guided by the public interest factors in *Steadman v. SEC*:[34] the egregiousness of the respondent's actions; the isolated or recurrent nature of the infraction; the degree of scienter involved; the sincerity of the respondent's assurances against future violations; the respondent's recognition of the wrongful nature of his conduct; and the likelihood of future violations.[35] Our inquiry into the appropriate remedial sanction "'is a flexible one, and no one factor is dispositive.'"[36]

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[33] "Naked" short selling "refers generally to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle." *"Naked" Short Selling Antifraud Rule,* Exchange Act Rel. No. 58774 (Oct. 14, 2008), 94 SEC Docket 10733, 10734 & n.2.

[34] 603 F.2d 1126 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981); *see Herbert M. Campbell, II, Esq.*, Initial Decision Rel. No. 266 (Oct. 27, 2004), 83 SEC Docket 4000, 4009 (ALJ decision) (applying *Steadman* factors in proceeding under Rule of Practice 102(e)), *declared final*, Exchange Act Rel. No. 50906 (Dec. 22, 2004), 84 SEC Docket 1943.

[35] *Steadman*, 603 F.2d at 1140.

[36] *David Henry Disraeli*, Exchange Act Rel. No. 57027 (Dec. 21, 2007), 92 SEC Docket 852, 875 (quoting *Seghers,* 91 SEC Docket at 2298), *aff'd,* 2009 WL 1791547 (D.C. Cir. 2009) (per curiam) (unpublished).

We have repeatedly stated that "conduct that violates the antifraud provisions of the federal securities laws is especially serious and subject to the severest of sanctions."[37] "'Fidelity to the public interest' requires a severe sanction when a respondent's misconduct involves fraud because the 'securities business is one in which opportunities for dishonesty recur constantly.'"[38] We have also stated, in the analogous context of a "follow-on" proceeding,[39] that an antifraud injunction "ordinarily" warrants barring participation in the securities industry.[40] We have further stated that "[t]he registration requirements [of the federal securities laws] are the heart of the securities regulatory system," and indicated that disregarding those requirements justifies "strong remedial measures."[41]

In this case, Gunderson's violations were egregious, recurrent, and reflected a high degree of scienter. As the district court found, over a period of several years, Gunderson "deliberately or at least recklessly and on repeated occasion" violated the federal securities laws by facilitating the issuance of hundreds of millions of unregistered Universal Express shares into the market and by participating in the creation and dissemination of materially misleading press releases to the investing public concerning Universal Express's business prospects. As the district court further found, Gunderson's "apparent disregard for the [federal securities] law," evidenced by his "repeated[] approv[al] and contribu[tion] to acts of fraud and noncompliance with investor-protecting registration requirements," was "particularly egregious given his position [at the time of the violations] as the chief lawyer for a publicly held company."[42]

Gunderson has not acknowledged his unlawful conduct, nor has he offered assurances against future violations. Instead, Gunderson argues that disqualifying him from appearing and

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37 *Justin F. Ficken*, Advisers Act Rel. No. 2803 (Oct. 17, 2008), 94 SEC Docket 10887, 10891 & n.20 (citing cases).

38 *Ficken*, 94 SEC Docket at 10891 (quoting *Richard C. Spangler, Inc.*, 46 S.E.C. 238, 252 (1976)).

39 An administrative proceeding that seeks to impose sanctions after an individual is enjoined from acts involving securities or investment fraud in federal court is commonly called a "follow-on" proceeding. *Gibson v. SEC*, 561 F.3d 548, 550 n.1 (6th Cir. 2009).

40 *Ficken*, 94 SEC Docket at 10891 (quoting *Marshall E. Melton*, 56 S.E.C. 695, 713 (2003)).

41 *Charles F. Kirby*, 56 S.E.C. 44, 72 (2003), *petition denied sub nom. Geiger v. SEC*, 363 F.3d 481 (D.C. Cir. 2004); *see generally SEC v. Ralton Purina Co.*, 346 U.S. 119, 124 (1953) (stating that the purpose of the registration requirements is to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions").

42 *Universal Express*, 475 F. Supp.2d at 430.

practicing before the Commission is not necessary to protect Universal Express's shareholders or public investors because he is no longer general counsel for Universal Express. However, Gunderson continues to be a licensed attorney, and thus remains in a position to commit future securities law violations on behalf of other clients.[43]

The contempt proceeding before the district court further indicates the likelihood of future violations. The district court found that Gunderson helped Universal Express issue tens of billions more unregistered shares, despite the permanent injunction and penny stock bar, based on "specious justifications" that demonstrated "active and willful disobedience of court orders."[44] The fact that Gunderson continued to violate the federal securities laws, in defiance of the district court's permanent injunction and penny stock bar, demonstrates a strong likelihood of Gunderson committing future violations. As the district court found, "there is . . . much cause to expect future misconduct by Gunderson."[45] Gunderson consequently poses a threat of future harm to the Commission's registration and disclosure processes, and thereby to the investing public.

Over thirty-five years ago, we noted the "strategic and especially central place of the private practicing lawyer in the investment process and in the enforcement of the body of federal law aimed at keeping that process fair."[46] We further noted that

> the task of enforcing the securities laws rests in overwhelming measure on the bar's shoulders. . . . [T]his Commission with its small staff, limited resources, and onerous tasks is peculiarly dependent on the probity and the diligence of the professionals who practice before it. Very little of a securities lawyer's work is adversary in character. . . . He works in his office where he prepares prospectuses, proxy statements, opinions of counsel and other documents that we, our staff, the financial community, and the investing public must take on faith. This is a field where unscrupulous lawyers can inflict irreparable harm on those who rely on the

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43 *See Campbell,* 83 SEC Docket at 4009-10 (permanently disqualifying attorney who, as corporate vice president and general counsel, was enjoined from violating federal securities laws, in part because he could continue practicing commercial law); *see generally William R. Carter*, 47 S.E.C. 471, 477 (1981) (stating that "[a] significant failure to perform properly the professional's role has implications extending beyond the particular transaction involved, for wrongdoing by a lawyer or an accountant raises the spectre of a replication of that conduct with other clients").

44 *Universal Express,* 2007 WL 2469452, at *5.

45 *Universal Express*, 475 F. Supp. 2d at 430.

46 *Emanuel Fields*, 45 S.E.C. 262, 266 n.20 (1973), *aff'd without opinion*, 495 F.2d 1085 (D.C. Cir. 1974).

> disclosure documents that they produce. Hence we are under a duty to hold our bar to appropriately rigorous standards of professional honor.[47]

Based on our consideration of the public interest factors and all of the circumstances in this case, we conclude that permanently disqualifying Gunderson from appearing or practicing before the Commission serves the public interest and is remedial because it will protect the integrity of our registration and disclosure processes from future harm by Gunderson.[48]

An appropriate order will issue.[49]

By the Commission (Chairman SCHAPIRO and Commissioners CASEY, WALTER, AGUILAR and PARADES).

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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[47] *Id.*; *see also SEC v. Spectrum, Ltd.*, 489 F.2d 535, 541-42 (2d Cir. 1973) (stating that "[t]he legal profession plays a unique and pivotal role in the effective implementation of the securities laws," and "[q]uestions of compliance with the intricate provisions of these statutes are ever present and the smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he renders an opinion on such matters"); *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir.) (stating that "[i]n our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar"), *cert. denied*, 377 U.S. 953 (1964).

[48] *See, e.g., Maxwell Bentley*, 46 S.E.C. 17, 18-19 (1975) (permanently disqualifying attorney enjoined from violating antifraud and registration provisions); *Fields*, 45 S.E.C. at 267-68 (same); *Campbell*, 83 SEC Docket at 4009-10 (permanently disqualifying attorney enjoined from violating antifraud and reporting provisions).

[49] 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. 61234 / December 23, 2009

Admin. Proc. File No. 3-12653

In the Matter of

CHRIS G. GUNDERSON, ESQ.

ORDER IMPOSING REMEDIAL SANCTIONS

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

ORDERED that Chris G. Gunderson be, and he hereby is, permanently disqualified from appearing or practicing before the Commission.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release No. IA-2965A; File No. S7-23-07]

RIN 3235-AJ96

Temporary Rule Regarding Principal Trades with Certain Advisory Clients

AGENCY: Securities and Exchange Commission.

ACTION: Final rule; correction.

SUMMARY: On December 30, 2009, the Securities and Exchange Commission published a Federal Register document adopting as final Rule 206(3)-3T under the Investment Advisers Act of 1940, the interim final temporary rule that establishes an alternative means for investment advisers who are registered with the Commission as broker-dealers to meet the requirements of Section 206(3) of the Investment Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients. As adopted, the only change to the rule was the expiration date. Rule 206(3)-3T will sunset on December 31, 2010. This document makes a correction to that document.

DATES: Effective [Insert date of filing for public inspection at the Office of the Federal Register]. The DATES section for FR Doc. 2009-30877, published on December 30, 2009 (74 FR 69009) is corrected to read "DATES: The amendments in this document are effective December 30, 2009 and the expiration date for 17 CFR 275.206(3)-3T is extended to December 31, 2010".

FOR FURTHER INFORMATION CONTACT: Sarah A. Bessin, Assistant Director, Daniel S. Kahl, Branch Chief, or Matthew N. Goldin, Senior Counsel, at (202) 551-6787 or IArules@sec.gov, Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5041.

SUPPLEMENTARY INFORMATION:

The Securities and Exchange Commission is correcting the DATES section for FR Doc. 2009-30877, published on December 30, 2009 (74 FR 69009), to read "DATES: The amendments in this document are effective December 20, 2009 and the expiration date for 17 CFR 275.206(3)-3T is extended to December 31, 2010."

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

December 31, 2009

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release No. IA-2965; File No. S7-23-07]

RIN 3235-AJ96

Temporary Rule Regarding Principal Trades with Certain Advisory Clients

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting as final Rule 206(3)-3T under the Investment Advisers Act of 1940, the interim final temporary rule that establishes an alternative means for investment advisers who are registered with the Commission as broker-dealers to meet the requirements of Section 206(3) of the Investment Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients. As adopted, the only change to the rule is the expiration date. Rule 206(3)-3T will sunset on December 31, 2010.

DATES: Effective Date: [Insert date of publication in Federal Register], 2009, except 17 CFR 275.206(3)-3T will expire and no longer be effective on December 31, 2010.

FOR FURTHER INFORMATION CONTACT: Sarah A. Bessin, Assistant Director, Daniel S. Kahl, Branch Chief, or Matthew N. Goldin, Senior Counsel, at (202) 551-6787 or IArules@sec.gov, Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5041.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is adopting as final temporary Rule 206(3)-3T [17 CFR 275.206(3)-3T] under the Investment Advisers Act of 1940 [15 U.S.C. 80b].

I. BACKGROUND

On September 24, 2007, we adopted, on an interim final basis, Rule 206(3)-3T, a temporary rule under the Investment Advisers Act of 1940 (the "Advisers Act") that provides an alternative means for investment advisers who are registered with us 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.[1] The purpose of the rule was to permit broker-dealers to sell to their advisory clients, in the wake of Financial Planning Association v. SEC (the "FPA Decision"),[2] certain securities held in the proprietary accounts of their firms that might not be available on an agency basis – or might be available on an agency basis only on less attractive terms[3] – while protecting clients from conflicts of interest as a result of such transactions.[4]

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1 Rule 206(3)-3T [17 CFR 275.206(3)-3T]. All references to Rule 206(3)-3T and the various sections thereof in this Release are to 17 CFR 275.206(3)-3T and its corresponding sections. See also Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 2653 (Sep. 24, 2007) [72 FR 55022 (Sep. 28, 2007)] ("2007 Principal Trade Rule Release").

2 482 F.3d 481 (D.C. Cir. 2007). In the FPA Decision, handed down on March 30, 2007, the Court of Appeals for the District of Columbia Circuit vacated (subject to a subsequent stay until October 1, 2007) Rule 202(a)(11)-1 under the Advisers Act. Rule 202(a)(11)-1 provided, among other things, that fee-based brokerage accounts were not advisory accounts and were thus not subject to the Advisers Act. For further discussion of fee-based brokerage accounts, see 2007 Principal Trade Rule Release, Section I.

3 See 2007 Principal Trade Rule Release at nn.19-20 and Section VI.C.

4 As a consequence of the FPA Decision, broker-dealers offering fee-based brokerage accounts became subject to the Advisers Act with respect to those accounts, and the client relationship became fully subject to the Advisers Act. These broker-dealers – to the extent they wanted to continue to offer fee-based accounts and met the requirements for registration – had to register as investment advisers, if they had not done so already, act as fiduciaries with respect to those clients, disclose all material conflicts of interest,

The rule vacated in the FPA Decision had allowed broker-dealers to offer fee-based accounts without complying with the Advisers Act, including the requirements of Section 206(3). Section 206(3) makes is unlawful for any investment adviser, directly or indirectly, "acting as a principal for his own account, knowingly to sell any security to or to 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."[5] Prior to our adoption of Rule 206(3)-3T, several firms that had offered fee-based brokerage accounts informed our staff that the written disclosure and the client consent requirements of Section 206(3) act as an operational barrier to their ability to engage in principal trades with their clients. Most informed us that they planned to discontinue fee-based brokerage accounts as a result of the FPA decision. They explained that they planned to do so because of the application of the Advisers Act and that, unless they were provided an exemption from (or an alternative means of complying with) Section 206(3), they would be unable to provide the same range of services to those fee-based brokerage customers who elected to become advisory clients and would expect few to elect to do so.

Rule 206(3)-3T was designed to continue to provide the protection of transaction-by-transaction disclosure and consent[6] to advisory clients when investment advisers seek

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and otherwise fully comply with the Advisers Act, including the restrictions on principal trading contained in Section 206(3) of the Act. See 2007 Principal Trade Rule Release, Section I.

5 15 U.S.C. 80b-6(3) (emphasis added). See also 2007 Principal Trade Rule Release, Section II.A.

6 Rule 206(3)-3T(a)(4). See also 2007 Principal Trade Rule Release, Section II.B.4.

to trade with them on a principal basis, subject to several conditions.[7] Specifically, Rule 206(3)-3(T) permits an adviser, with respect to non-discretionary advisory accounts,[8] to comply with Section 206(3) of the Advisers Act by, among other things, meeting the following conditions:

(i) providing written, prospective disclosure regarding the conflicts arising from principal trades;[9]

(ii) obtaining written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions;[10]

(iii) making certain disclosures, either orally or in writing, and obtaining the client's consent before each principal transaction;[11]

(iv) sending to the client confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction;[12] and

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7 For a discussion of Section 206(3) of the Advisers Act, its legislative history and our past interpretations of it, see the 2007 Principal Trade Rule Release, Section II.A.

8 For purposes of the rule, the term "investment discretion" has the same meaning as in Section 3(a)(35) of the Exchange Act [15 U.S.C. 78c(a)(35)], except that it excludes investment discretion granted by a customer on a temporary or limited basis. Rule 206(3)-3T(a)(1). See also 2007 Principal Trade Rule Release at n. 31.

9 Rule 206(3)-3T(a)(3). See also 2007 Principal Trade Rule Release, Section II.B.3.

10 Rule 206(3)-3T(a)(3). Rule 206(3)-3T also requires an adviser seeking to rely on the rule to include with each written disclosure required by the rule a conspicuous, plain English statement that the client may revoke the prospective, written consent without penalty at any time by written notice to the investment adviser. Rule 206(3)-3T(a)(8). See also 2007 Principal Trade Rule Release, Section II.B.3.

11 Rule 206(3)-3T(a)(4). See also 2007 Principal Trade Rule Release, Section II.B.4.

12 Rule 206(3)-3T(a)(5). See also 2007 Principal Trade Rule Release, Section II.B.5.

(v) delivering to the client an annual report itemizing the principal transactions made during the year.[13]

The rule also requires that the investment adviser be registered as a broker-dealer under Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act") [15 U.S.C. 78o] and that each account for which the adviser relies on the rule be a brokerage account subject to the Exchange Act, and the rules thereunder, and the rules of the self-regulatory organization(s) ("SRO") of which it is a member.[14] The rule is not available 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.[15] The rule includes one exception – an adviser may rely on the rule for trades in which the adviser or a control person is an underwriter of non-convertible investment-grade debt securities.[16] Rule 206(3)-3T(b) clarifies that the rule does not relieve in any way an investment adviser from its obligation to act in the best interests of each of its advisory clients, including fulfilling the duty with respect to the best price and execution for a particular transaction for the advisory client.[17] Rule 206(3)-3T was set to expire on December 31, 2009, approximately 27 months after its adoption.[18]

II. DISCUSSION

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13 Rule 206(3)-3T(a)(6). See also 2007 Principal Trade Rule Release, Section II.B.6.

14 Rule 206(3)-3T(a)(7). See also 2007 Principal Trade Rule Release, Section II.B.7.

15 Rule 206(3)-3T(a)(2). See also 2007 Principal Trade Rule Release, Section II.B.2.

16 Rule 206(3)-3T(a)(2). See also 2007 Principal Trade Rule Release, Section II.B.2. A separate Commission rulemaking may have an impact on the rule's definition of "non-convertible investment grade debt securities." See note 34 below.

17 Rule 206(3)-3T(b). See also 2007 Principal Trade Rule Release, Section II.B.8.

18 Rule 206(3)-3T(d). See also 2007 Principal Trade Rule Release, Section II.B.9.

We are adopting Rule 206(3)-3T in the same form in which we adopted it on an interim final basis in 2007, except that the sunset period of the rule will end one year later (on December 31, 2010). Absent further action by the Commission, Rule 206(3)-3T will expire on December 31, 2010. As we continue to assess the operation of the rule along with intervening developments, we believe that the substantive provisions of Rule 206(3)-3T as it was adopted on an interim final basis provide sufficient protections to advisory clients to warrant its continued operation for an additional limited period of time. We will use that time to consider whether to propose to continue the rule beyond the revised sunset date and, if so, what if any modifications should be made to the rule.

a. **Comments on the Scope and Conditions of the Rule**

We received comment letters from eight commenters on the interim final rule.[19] Several favored narrowing the scope of the exemption provided by the rule or opposed its expansion.[20] Others, however, urged us to expand the rule's exemption to cover additional securities.[21] Some commenters suggested that an adviser be prohibited from relying on the rule when trading any securities underwritten or issued by the adviser or any of its affiliates (i.e., that we exclude underwritten non-convertible investment grade

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[19] The comment letters are available at www.sec.gov/comments/s7-23-07/s72307.shtml. However, one additional comment letter was submitted in connection with our proposed Interpretive Rule under the Advisers Act Affecting Broker-Dealers, Investment Advisers Act Release No. 2652 (Sep. 24, 2007). International Association of Small Broker Dealers and Advisers (Oct. 25, 2007) ("IASBDA Letter.") The IASBDA Letter addresses one particular aspect of the rule, as noted below, and is available at www.sec.gov/comments/s7-22-07/s72207-3.pdf.

[20] See, e.g., Comment Letter of the Financial Planning Association (Nov. 30, 2007) ("FPA Letter I"); Comment Letter of the National Association of Personal Financial Advisors (Nov. 30, 2007) ("NAPFA Letter").

[21] See, e.g., Comment Letter of the Securities Industry and Financial Markets Association (Nov. 30, 2007) ("SIFMA Letter I"); Comment Letter of Davis Polk & Wardwell (Dec. 4, 2007) ("DPW Letter").

debt securities).[22] Others asked that we allow advisers, in reliance on the rule, to engage in principal trades with clients in various types of securities the adviser or an affiliate underwrote that are highly liquid and for which ascertainable prices are readily available.[23]

Some commenters generally viewed the protections afforded to clients under the rule as inadequate,[24] while others urged us to modify the rule to make it easier for advisers to effect principal transactions with their clients.[25] For example, one commenter urged us to limit the rule's relief to principal transactions with sophisticated or wealthy investors who are in a position to protect themselves.[26] Another suggested the rule expressly require firms to develop policies and procedures that are specifically designed to detect, deter and prevent disadvantageous principal transactions.[27] And others suggested that we require that the disclosure supporting the initial client authorization for principal trades be in a separately executed, stand-alone document and not permit it to be incorporated directly into an account opening agreement.[28] Some commenters asserted, however, that the disclosure requirements – in particular, requiring transaction-by-transaction disclosures for principal trades with sophisticated investors – were too restrictive,[29] while others argued that they did not go far enough.[30] Some commenters

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22 See, e.g., Comment Letter of Fund Democracy and the Consumer Federation of America (Nov. 30, 2007) ("FD/CFA Letter").

23 See, e.g., SIFMA Letter I.

24 See, e.g., NAPFA Letter.

25 See, e.g., DPW Letter.

26 FPA Letter I.

27 FD/CFA Letter.

28 See, e.g., FD/CFA Letter; NAPFA Letter; FPA Letter I.

suggested we impose additional disclosures or disclosure-related requirements.[31] One commenter questioned the rule's overall focus on disclosure and urged us to consider instead requiring affirmative measures designed to prevent principal trading abuses.[32]

Commenters who addressed the issue generally agreed with our view that principal trades in securities issued or underwritten by an adviser or its control persons should not be permitted under the rule.[33] However, these commenters expressed differing views with respect to the rule's exception from the general prohibition for trades in which the adviser or control person is an underwriter of non-convertible investment grade debt securities.[34] We also received mixed comments on the rule's limitation of relief to

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29 See, e.g., DPW Letter (although supporting the rule, commenting that the Commission should provide more relief from the restrictions of Section 206(3) to permit affirmative waiver of the transaction-by-transaction disclosure and consent requirements with respect to transactions with financially sophisticated investors involving certain "readily marketable" securities).

30 See, e.g., Comment Letter of the Investment Advisers Association (Nov. 30, 2007) ("IAA Letter") (expressing strong opposition to any expansion of the relief provided in the rule, or relaxation of the rule's conditions, and emphasizing the importance of monitoring the rule in practice before making further changes); FPA Letter I (expressing concern about the risks attendant to principal trades); NAPFA Letter (arguing that any expansion of the scope of the rule would be inappropriate because of the potential risks associated with principal trades).

31 See, e.g., FD/CFA Letter; FPA Letter I (expressing concern that the transaction-specific disclosures required by the rule may not provide investors with enough information regarding conflicts of interest and suggested additional disclosures that should be required by the rule).

32 See note 27 above and accompanying text.

33 See, e.g., FD/CFA Letter; FPA Letter I; SIFMA Letter I.

34 Compare SIFMA Letter I (arguing that we should expand the exception to underwritten preferred stock, convertible debt, and certificates of deposit (among others)) with FPA Letter I (specifically urging us not to extend the exception to debt instruments other than investment grade municipal debt and corporate debt and expressing concern with price transparency of debt instruments, generally) and FD/CFA Letter (arguing that the exception should not be further expanded or that it should be eliminated altogether because of concerns regarding the price transparency of debt instruments).

One commenter supporting a broadening of the exception also urged us to modify our definition of "investment grade debt security" to require that a qualifying security receive investment advisers that are registered with the Commission as broker-dealers. Some commenters, generally those representing financial institutions that act as both advisers and broker-dealers, supported the limitation[35] while others opposed it.[36]

Several commenters agreed with our decision to limit the rule to non-discretionary accounts.[37] In contrast, one commenter urged us to expand the rule to be

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ratings from only one nationally recognized statistical rating organization ("NRSRO") instead of two. SIFMA Letter I. We are considering more globally, and in a separate rulemaking, whether our inclusion of requirements related to credit ratings in our rules and forms as an indication of investment grade quality has, in effect, placed an "official seal of approval" on ratings and has adversely affected the quality of due diligence and investment analysis. See References to Ratings of Nationally Recognized Statistical Rating Organizations in Rules Under the Investment Company Act and Investment Advisers Act, Investment Company Act Release No. 28327 (Jul. 1, 2008) [73 FR 40124 (July 11, 2008)]. In conjunction with recently reopening the comment period for the proposal with respect to Rule 206(3)-3T, the Commission requested comment on whether it should substitute an approach that uses credit ratings as a minimum standard along with additional criteria that must be met with regard to evaluating securities. The re-opened comment period closed on December 8, 2009. See References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28939 (Oct. 5, 2009) [74 FR 52358 (Oct. 9, 2009)].

35 See, e.g., SIFMA Letter I (arguing that the dual registration condition preserves important investor protections that were available to former fee-based brokerage customers who elected after the FPA Decision to convert their accounts to advisory accounts).

36 See, e.g., FPA Letter I (urging us to eliminate the limitation because investors would already receive the protections of both the Advisers Act and the Exchange Act whether the adviser is itself also registered as a broker-dealer or whether it is simply affiliated with a broker-dealer, and further arguing that that the condition may have anticompetitive effects, providing an advantage to investment advisers that are also registered as broker-dealers); Comment Letter of the American Bar Association, section of Business Law's Committee on Federal Regulation of Securities (Apr. 18, 2008) ("ABA Committee Letter") (arguing that the substantial regulatory burdens of applying two regulatory regimes is not offset by additional investor protection benefits).

37 See, e.g., FD/CFA Letter (arguing that discretionary accounts present a "greater risk of abuse as a general matter" and expressed appreciation for the protections provided by this limitation); IAA Letter; SIFMA Letter I (agreeing that the rule should apply to all non-discretionary accounts, but specifically noting that the rule should not be further limited in application to former fee-based brokerage accounts only); FPA Letter I (supporting the limitation as providing a critical investor protection, but arguing that we should consider further narrowing the non-discretionary account limitation to include only those accounts that were formerly fee-based brokerage accounts).

available to all advisory accounts, not just non-discretionary ones.[38] One commenter urged us to limit the scope of the rule so that advisers may only rely on it when they are conducting a principal trade with a "qualified client," as defined under Rule 205-3 [17 CFR 275.205-3] under the Advisers Act,[39] while another argued that the rule should not be restricted to particular clients.[40]

b. Comments on Sunset Provision

Five commenters addressed the duration of Rule 206(3)-3T.[41] Three expressed support for the temporary duration of the rule, arguing that, in light of the substantial risks associated with principal trading facilitated by the rule, a temporary effectiveness period would be important for the Commission to assess whether the scope of relief provided by the rule is appropriate.[42] Two commenters supported making the rule permanent at the end of the sunset provision with broadened relief.[43]

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38 ABA Committee Letter (arguing that the specific exclusion in the rule for adviser-underwritten securities, together with an adviser's best execution obligations, provides investors with sufficient investor protections and therefore clients in discretionary accounts should not be precluded from the benefits of the relief provided by the rule).

39 FPA Letter I (further arguing that institutional clients or natural persons who are deemed to be "qualified clients" for purposes of Rule 205-3 are better positioned to understand the nature of principal transactions and the potential conflicts and, therefore, are better able to protect themselves against potential abuses than are other investors). Another commenter also expressed general objections to the placing of any principal trades by investment advisers. NAPFA Letter.

40 SIFMA Letter I (noting that all investors should be able to benefit from the greater investment choices, potentially enhanced executions and additional liquidity provided by the rule).

41 FPA Letter I; Comment Letter of the Financial Planning Association (Sep. 16, 2008) ("FPA Letter II"); IAA Letter; SIFMA Letter I; Comment Letter of the Securities Industry and Financial Markets Association (Aug. 21, 2009) ("SIFMA Letter II"); DPW Letter; NAPFA Letter.

42 FPA Letter I; IAA Letter; NAPFA Letter.

43 DPW Letter; SIFMA Letter I.

We received two subsequent letters from market participants. The Securities Industry and Financial Markets Association (SIFMA) urged us to extend the temporary rule for two years in light of pending legislation that could address principal trading by investment advisers.[44] The Financial Planning Association (FPA) also wrote recommending allowing the rule to expire or extending it for no more than an additional year while the Commission conducts a study that either substantiates a clear basis for adopting a permanent exemption under Section 206(3) or disproves the view of firms that it affords unique benefits to the public.[45]

c. Limited Extension of Temporary Rule

When we adopted Rule 206(3)-3(T) on a temporary basis in September 2007, we anticipated the two-year period would provide us with adequate time to evaluate the operation of the rule in the marketplace and determine, in conjunction with consideration of all comments received, whether the rule should be made permanent, modified or allowed to expire. At the time we adopted the interim final rule, we explained that we would need to take action no later than the end of the original duration of the temporary rule if we intended to continue the same or similar relief.[46]

We need additional time to understand how, and in what situations, advisers are using the rule. Fewer firms than we anticipated at the time we adopted the rule on an interim final basis immediately determined to rely on it and those that did were slower than expected to implement the rule. We take seriously the investor protection concerns raised by commenters. Consequently, we have determined to limit the duration of the

44 SIFMA Letter II.

45 FPA Letter II.

46 See 2007 Principal Trade Rule Release, Section II.B.9.

extension to one year while we continue to evaluate the operation of the rule. As our staff continues to gather information, we will assess whether the rule is operating, and firms are applying it, in a manner consistent with protecting investors.

Given the limited nature of the extension, we believe that making other changes to the temporary rule could cause firms relying on the rule to need to make adjustments to their disclosure documents, client agreements, procedures, or systems that, depending on whether we determine to propose and adopt a permanent rule in the future, may be applicable for only a year.

Further evaluation will help inform our decision whether to propose to make the rule permanent in its current or an amended form or to allow it to expire.[47] We will consider, among other things, the comments we received on the interim final rule in deciding whether to propose a permanent rule or to let the rule expire. If we decide to propose a permanent rule, we will also consider the comments we received in determining how such a rule might differ from Rule 206(3)-T.

In addition, there are currently pending before both houses of Congress bills that may address, or otherwise have an impact on, principal trading activities by investment advisers and broker-dealers, as well as broader issues under the Advisers Act.[48] Waiting some additional time for Congress to act will permit us to consider the impact that any of

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47 Subsequent to adopting Rule 206(3)-3T, the study prepared by RAND Corporation was completed. See Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf. The study addressed two primary questions: (1) what are the current business practices of broker-dealers and investment advisers; and (2) do investors understand the differences between and relationships among broker-dealers and investment advisers? Several of the bills currently pending before Congress are designed to harmonize the separate regulatory regimes for investment advisers and broker-dealers.

48 See, e.g., Investor Protection Act of 2009, H.R. 3817, 111th Cong. (2009); Restoring American Financial Stability Act of 2009, S. ____ 111th Cong. (2009).

those proposals, if enacted, will have on such activities prior to taking further action with respect to the temporary rule.

For the reasons discussed in this release, we have determined that it is necessary or appropriate in the public interest and consistent with the protection of investors and consistent with the purposes fairly intended by the policy and provisions of the Advisers Act to adopt Rule 206(3)-T as a final temporary rule. We are adopting Rule 206(3)-3T in the same form in which we originally adopted it on an interim final basis, except that it will expire on December 31, 2010, one year after its original expiration date.

III. CERTAIN ADMINISTRATIVE LAW MATTERS

The amendment to Rule 206(3)-3T is effective on [insert date of publication in the Federal Register]. The Administrative Procedure Act generally requires that an agency publish a final rule in the Federal Register not less than 30 days before its effective date.[49] However, this requirement does not apply if the rule is a substantive rule which grants or recognizes an exemption or relieves a restriction, or if the rule is interpretive.[50] Rule 206(3)-3T in part has interpretive aspects and is a rule that recognizes an exemption and relives a restriction.

IV. PAPERWORK REDUCTION ACT

Rule 206(3)-3T contains "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[51] The Office of Management and Budget ("OMB") approved the burden estimates presented in the 2007 Principal Trade

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49 5 U.S.C. 553(d).

50 5 U.S.C. 553(d)(1) and (2).

51 44 U.S.C. 3501 et seq.

Rule Release,[52] first on an emergency basis and subsequently on a regular basis. OMB approved the collection of information with an expiration date of March 31, 2011. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The title for the collection of information is: "Temporary rule for principal trades with certain advisory clients, rule 206(3)-3T" and the OMB control number for the collection of information is 3235-0630.

The 2007 Principal Trade Rule Release explains that, under Rule 206(3)-3T, there are four distinct collection burdens. Our estimate of the burden of each of the collections reflects the fact that the alternative means of compliance provided by the rule is substantially similar to the approach advisers currently employ to comply with the disclosure and consent obligations of Section 206(3) of the Advisers Act and the approach that broker-dealers employ to comply with the confirmation requirements of Rule 10b-10 under the Exchange Act. The 2007 Principal Trade Rule Release solicited comments on our PRA estimates,[53] but we did not receive comment on them. The amendment to the rule we are adopting today – to extend the rule for twelve months – does not affect the burden estimates contained in the 2007 Principal Trade Rule Release.[54]

V. COST-BENEFIT ANALYSIS

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52 See 2007 Principal Trade Rule Release, Section V.B&C.

53 See id., Section V.D.

54 As discussed above, fewer firms than we anticipated at the time we adopted the rule on an interim final basis immediately determined to rely on it and those that did were slower than expected in implementing it. We received no comments on our estimate of the number of advisers or accounts and, for purposes of this release, are retaining those estimates.

We are adopting, as a final temporary rule, Rule 206(3)-3T under the Advisers Act, which provides an alternative means for investment advisers that are registered with us as broker-dealers to meet the requirements of Section 206(3) when they act in a principal capacity with respect to transactions with certain of their advisory clients. Other than extending the sunset period of the temporary rule for one year, we are not otherwise modifying the rule from the form in which we initially adopted it on an interim final basis in September 2007.

In summary, as explained in the 2007 Principal Trade Rule Release,[55] we believe the principal benefit of Rule 206(3)-3T is that it maintains investor choice and protects the interests of investors who held an estimated $300 bullion in one million fee-based brokerage accounts. A resulting second benefit of the rule is that non-discretionary advisory clients of advisory firms that are also registered as broker-dealers have easier access to a wider range of securities which, in turn, should lead to increased liquidity in the markets for these securities and promote capital formation in these areas. A third benefit of the rule is that it provides the protections of the sales practice rules of the Exchange Act and the relevant self-regulatory organizations because an adviser relying on the rule must also be a registered broker-dealer. Another benefit of Rule 206(3)-3T is that it provides a lower cost alternative for an adviser to engage in principal transactions.

We believe there are some benefits associated with extension of the rule for one year. By extending the rule for one year, non-discretionary advisory clients who have had access to certain securities because of their advisers' reliance on the rule to trade on a principal basis will continue to have access to those securities without disruption. Firms

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55 For a complete discussion of the benefits for Rule 206(3)-3T, see 2007 Principal Trade Rule Release, Section VI.

relying on the rule will continue to be able to offer clients and prospective clients access to certain securities on a principal basis as well and will not need during this one-year period to incur the cost of adjusting to a new set of rules or abandoning the systems established to comply with the current rule. In other words, extension will avoid disruption to clients and firms during the period while we consider whether to make the rule permanent in its current form or in a modified form or to let it expire.

As discussed in the 2007 Principal Trade Rule Release,[56] we presented estimates of the costs of each of the rule's disclosure elements, including: the prospective disclosure and consent; transaction-by transaction disclosure and consent; transaction-by-transaction confirmations; and the annual report of principal transactions. We also provided estimates for the following related costs of compliance with Rule 206(3)-3T: (i) the initial distribution of prospective disclosure and collection of consents; (ii) systems programming costs to ensure that trade confirmations contain all of the information required by the rule; and (iii) systems programming costs to aggregate already-collected information to generate compliant principal transactions reports.[57] Finally, we solicited comment on, and requested data to assist us in further developing, our cost and benefit estimates.[58]

We did not receive comments directly addressing with supporting data the cost-benefit analysis we presented in the 2007 Principal Trade Rule Release and we continue

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56 See 2007 Principal Trade Rule Release, Section VI.D.

57 We note that the rule provides an alternative means of compliance with Section 206(3) of the Advisers Act. Therefore, there is no requirement that any adviser rely on it. We believe that it is reasonable to assume that only those advisers that conclude that the benefits in aggregate outweigh the aggregate costs of relying on the rule would choose to do so.

58 See 2007 Principal Trade Rule Release, Section VI.

to believe that our estimates reflect the likely costs an adviser would incur to rely on the rule.[59] Several of the comments described above, however, relating to the utility of specific disclosure provisions, along with an additional comment regarding the potential effect of the rule on small firms, do have bearing on our cost-benefit analysis of the rule. In particular, one commenter argued that the costs of transaction-by-transaction notice and consent for sophisticated investors may outweigh the benefits.[60] This commenter suggested that the rule expressly permit negative consent for principal trading because the costs for certain clients who must locate and contact an authorized person to sign an affirmative consent on behalf of the client on a timely basis may outweigh the benefits.[61] Another commenter expressed doubt that the benefit of the transaction-by-transaction confirmation requirement would outweigh the costs of revising and further burdening the standard confirmation form, especially given the rule's other disclosure and consent requirements.[62] Another commenter argued that limiting the availability of the rule to advisers that also are registered as broker-dealers imposes substantial regulatory burdens that are not justified by corresponding investor protection benefits.[63] We recognize these commenters' concerns and will consider them, as well as all the other comments we have received, if we determine to propose to make the rule permanent in its current or a modified form. For purposes of the limited extension at issue here, however, we believe

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59 As discussed above, fewer firms than we anticipated at the time we adopted the rule on an interim final basis immediately determined to rely on it. We received no comments on our estimate of the number of advisers or accounts and, for purposes of this release, are retaining our original estimates.

60 DPW Letter.

61 Id.

62 FD/CFA Letter.

63 ABA Committee Letter.

the costs of adjustments to practices and systems that may or may not be continued or necessary under a potential, future permanent rule would not be justified at this time.[64]

We acknowledge that firms relying on the rule would incur operational costs associated with complying with the rule for one year. We believe that the estimates of the costs we outlined were reasonable, and no commenter provided specific, alternative estimates. We believe that the benefits were appropriately identified. We believe that all the costs and benefits associated with the rule – which, as noted above, the purpose of which was to permit broker-dealers to sell to their non-discretionary advisory clients certain securities held in the proprietary accounts of their firms that might not be available on an agency basis (or might be available on an agency basis only on less attractive terms) should be considered in aggregate. The particular array of disclosure requirements and limitations contained in the rule was tailored to safeguard investor protection and counterbalance investor protection concerns that might stem from the rule's allowance for transaction-by-transaction notice and consent to principal trades to be delivered orally or in written form, instead of just in written form. We believe that, for purposes of this one-year extension of the rule, these overall benefits justify the costs associated with the rule.

VI. PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION

Section 202(c) of the Advisers Act mandates that the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, consider, in addition to the protection of

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64 See Section II.C. of this Release.

investors, whether the action will promote efficiency, competition, and capital formation.[65]

As we explained in the 2007 Principal Trade Rule Release, Rule 206(3)-3T may increase efficiency by providing an alternative means of compliance with Section 206(3) of the Advisers Act that we believe will be less costly and less burdensome.[66] By permitting oral transaction-by-transaction disclosure, advisers may be more willing to engage in principal trades with advisory clients leading advisers to provide access to certain securities the adviser or its affiliate has in inventory. As we noted in the 2007 Principal Trade Rule Release, firms have argued that making securities available to clients through principal trades could lead to faster or less expensive execution, advantages a client may deem to outweigh the risks presented by principal trading with an adviser.[67]

We further explained our expectation that Rule 206(3)-3T will promote competition because it preserves investor choice for different types of advisory accounts and that, if Rule 206(3)-3T has any effect on capital formation, it is likely to be positive, although indirect.[68] We also described our understanding that providing an alternative to the traditional requirements of transaction-by-transaction written disclosure might serve to broaden the potential universe of purchasers of securities, in particular investment grade debt securities, for the reasons described in the 2007 Principal Trade Rule Release,

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[65] 15 U.S.C. 80b-2(c).

[66] 2007 Principal Trade Rule Release, Section VII.

[67] Id.

[68] Id.

opening the door to greater investor participation in the securities markets with a potential positive effect on capital formation.[69]

Some commenters, while expressing support for the goal of affording investors engaged in principal transactions the protections of both the investment adviser regulatory regime (i.e., the Advisers Act and rules thereunder) and the broker-dealer regulatory regime (i.e., the Exchange Act and rules thereunder and the rules of applicable SROs), opposed the limitation of the temporary rule not only to investment advisers that are also registered as broker-dealers, but also to accounts that are subject to both the Advisers Act and Exchange Act.[70] One of these commenters specifically argued that these limitations are unnecessary, contending they provide no additional protection for investors engaging in principal transactions because any principal trades conducted for an advisory account would be subject to the Exchange Act and SRO rules anyway.[71] This commenter concluded that the limitation instead merely provides a competitive advantage to investment advisers that are also registered broker-dealers.[72]

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69 Id., Section II.B.2.

70 See, e.g., FPA Letter I; ABA Committee Letter; SIFMA Letter I. Another commenter commented upon potential anti-competitive aspects of the rule, in particular as it relates to a proposed (but not adopted) interpretive rule that was proposed on the same day Rule 206(3)-3T was adopted on an interim final basis. IASBDA Letter. See also note 19 above. Because those comments relate more directly to the proposed interpretive rule, they will be considered in conjunction with that interpretive rulemaking.

71 FPA Letter I (arguing that a client engaging in a principal trade enjoys the benefits of two regulatory regimes regardless of whether the client's adviser is itself both an investment adviser and a broker-dealer for purposes of the federal securities laws or instead affiliated with a separate broker-dealer with which the client engages in the trade on a principal basis because, in the first instance, a single firm is responsible for meeting all regulatory requirements (including those of the Commission and the relevant SRO) and in the second, one firm holds the broad fiduciary duties of an adviser (and is subject to Commission oversight), while the affiliated broker-dealer must still comply with the Commission's and relevant SRO's sales practice and best execution requirements).

72 Id.

We intend to continue to evaluate the effects of the rule on efficiency, competition and capital formation as we consider whether to propose to extend or modify the rule or allow it to expire. As discussed above, we have no reason to believe, based on our experience with the rule to date, that small broker-dealers (or affiliated but separate investment advisers and broker-dealers) are put at a competitive disadvantage to larger advisers that are themselves also registered as broker-dealers. We believe that the effects on efficiency, competition and capital formation of Rule 206(3)-3T as it was adopted on an interim final basis warrant its continued operation for the additional limited period of time. We anticipate no new effects on efficiency, competition and capital formation as a result of the one-year extension. During that time, we will continue to assess the rule's operation and impact along with intervening developments.

VII. FINAL REGULATORY FLEXIBILITY ACT ANALYSIS

A final regulatory flexibility analysis ("FRFA") was prepared in accordance with 5 U.S.C. 603 when Rule 206(3)-3T was adopted in September 2007. In the 2007 Principal Trade Rule Release, we analyzed: (i) the need for and objectives of the rule; (ii) an estimate of small entities subject to the rule; (iii) the rule's projected reporting, recordkeeping and other compliance requirements; (iv) agency action to minimize the effect on small entities; (v) duplicative, overlapping or conflicting federal rules; and (vi) significant alternatives. We sought comment on each of these aspects of our FRFA.

As discussed above, several commenters objected to the condition that advisers seeking to rely on the rule must also be registered as broker-dealers and that each account must be subject to both the Advisers Act and the Exchange Act (and applicable SRO rules). Some contended that the burdens of requiring application of both regulatory regimes do not outweigh the benefits.[73] Others essentially argued that limiting the availability of the relief under the rule to advisers also registered as broker-dealers might be anti-competitive.[74] With respect to small entities in particular, one commenter suggested that the alternative means of compliance with the Advisers Act's principal trading restrictions made available by Rule 206(3)-3T (in particular, when considered in conjunction with the interpretive rule proposed on the same day),[75] would disadvantage small broker-dealers because they are less likely to also be registered as an investment adviser, and as a result would have to form an adviser to take advantage of the benefits of the rule.[76]

We specifically considered and discussed these issues in the final regulatory flexibility analysis in the 2007 Principal Trade Rule Release and believe that it is appropriate to continue this condition of the rule for the limited extension. As explained above, however, we expect to continue to consider these comments in conjunction with data our staff gathers on the operation of the rule in the marketplace, no later than the end of the rule's revised termination date if the Commission intends to propose to continue the same or similar relief.

VIII. STATUTORY AUTHORITY

The Commission is adopting Rule 206(3)-3T pursuant to Sections 206A and 211(a) of the Advisers Act.

TEXT OF RULE

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73 See notes 35-36 and accompanying text above

74 See notes 70-72 and accompanying text above.

75 See note 19 above.

76 IASBDA Letter.

List of Subjects in 17 CFR Part 275

Investment advisers, Reporting and recordkeeping requirements.

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

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

1. The general authority citation for Part 275 continues to read 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.

* * * * *

2. Section 275.206(3)-3T(d) is amended to read as follows:

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

(d) This section will expire and no longer be effective on December 31, 2010.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: December 23, 2009

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9101 / December 28, 2009

SECURITIES EXCHANGE ACT OF 1934
Release No. 61246 / December 28, 2009

INVESTMENT ADVISERS ACT OF 1940
Release No. 2966 / December 28, 2009

INVESTMENT COMPANY ACT OF 1940
Release No. 29098 / December 28, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13730

In the Matter of **BAHRAM A. JAFARI and** **MOUNTAIN RESOURCES, INC.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, and SECTIONS 9(b) and 9(f) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND CEASE-AND-DESIST ORDERS**

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"), Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Mountain Resources, Inc. ("MRI"), and Section 8A of the Securities Act, Section 21C of the Exchange Act, Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act"), and Sections 9(b) and 9(f) of the Investment Company Act against Bahram A. Jafari ("Jafari") (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, Section 203(f) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders ("Order"), as set forth below.

III.

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

Summary

1. These proceedings arise from Jafari's and MRI's materially false and misleading statements to investors who purchased shares in MRI, an investment company run by Jafari. Jafari and MRI made the same false statements to investors for whom Jafari traded options in individual trading accounts maintained in the investors' names. Jafari represented to his victims that he was a capable and competent options trader who could generate profits for them. At the same time, he failed to disclose his dismal track record trading options. Jafari and MRI made other material misrepresentations to investors as well. Through his options trading, Jafari ultimately lost 100% of the funds that the investors entrusted to him.

Respondents

2. **Bahram A. Jafari,** age 69, is a resident of Denver, Colorado. Jafari incorporated MRI in 2001. He was a director and president of MRI and was in charge of its day to day activities including options trading. Jafari also was responsible for the options trading for the individual trading accounts. Jafari received compensation for securities trading for MRI in the form of MRI shares, and he was therefore an investment adviser under Section 202(a)(11) of the Investment Advisers Act. He was never registered in any capacity with any state or with the Commission.

3. **Mountain Resources, Inc.** is a Colorado corporation with no assets. MRI's business was investing in securities. MRI made an offering of securities that did not qualify for an exemption from registration and therefore it was an investment company under Section 3(c)(1) of the Investment Company Act. MRI never registered in any capacity with any state or with the Commission.

Facts and Violations

4. In or about 1985, Jafari began developing a proprietary trading program involving a combination of long and short stock positions and various call and put spread combinations. From 1999 through 2002 Jafari traded options for himself and family members. Then, in 2003 Jafari began soliciting other family members and friends to invest. He initially attracted new "friends and family" shareholders through one-on-one or small-group conversations. By June 2005, at least 36 individuals had invested a total of at least $1,948,956.

5. Jafari's investors fell into two groups. The first group consisted of twelve investors who gave him a total of approximately $760,000 in cash to invest. He pooled the cash to trade options in trading accounts opened in MRI's name. The second group consisted of investors who held individual trading accounts in their names. They gave Jafari/MRI discretionary trading authority over their accounts, and Jafari/MRI traded options in their accounts. These investors were known as "participative investors."

6. Jafari first prepared an offering document in early 2000, which he revised from time to time. The offering document provided that the business of MRI was to invest in securities. According to the offering document, investors could invest by either of two means: (1) purchase shares of MRI, with the price of the shares based on the total value of MRI's securities holdings divided by the number of outstanding shares or (2) become participative investors as noted above; participative investors were subject to a profit sharing arrangement between MRI and the investor.

7. Jafari did not file a registration statement with the Commission to register the offer and sale of MRI shares.

8. Jafari received no cash compensation for his trading of securities for MRI. He took 4,000 shares per month of MRI stock as his compensation for his securities trading for MRI. This stock became worthless because Jafari lost 100% of MRI's securities holdings through his trading. Neither he nor MRI shared profits with any participative investor.

9. In soliciting investors, Jafari represented that he was a competent and capable options trader who would generate profits for them. For example, at least two versions of Jafari's offering document included a table showing that the price per share for MRI stock had increased from $1.00 per share in July 1999 to $2.25 per share in July 2003 without any price decline between those dates. From time to time, Jafari also sent investors statements for their accounts showing substantial increases in MRI's share price. Jafari's representations about his options trading ability coupled with his representations about MRI's increasing share price fraudulently induced investors to invest initially and to increase the amount of their investments thereafter.

10. When making these statements, Jafari failed to disclose that his trading in the 1999 through 2002 timeframe produced an average loss of 52% in the ten brokerage accounts through which he made his trades. Thereafter, Jafari continued to lose his investors' funds through his trading. From time to time investors learned of losses in the accounts through which Jafari traded. Jafari

assured these investors that their losses were "paper losses" only. Jafari ultimately lost 100% of investors' funds through his trading.

11. The account statements that Jafari and MRI sent to investors made baseless and fictitious representations about the number of shares held by the investors and the share price. Among other things, Jafari and MRI created no records to track the value of MRI's holdings at any point in time. Thus, Jafari and MRI could not accurately determine the number of shares an investor initially bought and the price of each share. Jafari and MRI could not calculate an accurate new share price as the value of MRI's holdings fluctuated.

12. As the result of Jafari's conduct described above with respect to MRI's shareholders, he willfully violated and MRI violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. As the result of Jafari's conduct described above with respect to the participative investors, he willfully violated and MRI violated Section 10(b) of the Exchange Act and Rule 10b-5.

14. As the result of Jafari's and MRI's failure to file a registration statement for the offer and sale of securities by MRI, he willfully violated and MRI violated Sections 5(a) and (c) of the Securities Act.

15. As the result of MRI's failure to register with the Commission as an investment company, MRI, willfully aided and abetted and caused by Jafari, violated Section 7(a) of the Investment Company Act.

16. Jafari submitted a Sworn Statement of Financial Condition dated June 8, 2009, and other evidence, and Jafari has asserted his inability to pay a civil penalty.

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, Section 203(f) of the Advisers Act, and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Jafari cease and desist from committing or causing any violations and any future violations of Sections 5(a), 5(c) and 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and from causing any violations and any future violations of Section 7(a) of the Investment Company Act;

B. Respondent Jafari be, and hereby is, barred from association with any investment adviser, and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter;

C. Any reapplication for association by Respondent Jafari 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;

D. Respondent MRI cease and desist from committing or causing any violations and any future violations of Sections 5(a), 5(c) and 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 7(a) of the Investment Company Act;

E. Based upon Jafari's sworn representations in his Statement of Financial Condition dated June 8, 2009, and other documents submitted to the Commission, the Commission is not imposing a penalty against Jafari; and

F. The Division of Enforcement ("Division") may, at any time following the entry of this Order, petition the Commission to reopen this matter to consider whether Respondent Jafari provided accurate and complete financial information at the time such representations were made, and (2) seek an order against Jafari directing payment of the maximum civil penalty allowable under the law. No other issue shall be considered in connection with this petition other than whether the financial information provided by Respondent Jafari was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondent Jafari may not, by way of defense to any such petition: (1) contest the findings in this Order; (2) assert that payment of a penalty should not be ordered; (3) contest the imposition of the maximum penalty allowable under the law; or (4) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61245 / December 28, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3090 / December 28, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13729

In the Matter of	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**
ANNA M. BAIRD, CPA	
Respondent.	

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Anna M. Baird ("Respondent" or "Baird") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and

[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.

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. Baird, age 52, has been a certified public accountant licensed to practice in the Commonwealth of Pennsylvania. She served as Chief Financial Officer, Vice President and Treasurer of Black Box Corporation ("Black Box") from May 1997 until December 2002. Baird was licensed as a CPA in Pennsylvania from 1982 through early 2003, when her license lapsed.

2. Black Box is a Delaware corporation with its principal place of business in Lawrence, PA. Black Box is a network infrastructure services provider of communication systems. At all relevant times, Black Box's common stock was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act") and traded on NASDAQ's Global Select Market System under the symbol "BBOX."

3. On December 4, 2009, the Commission filed a complaint against Baird in *SEC v. Black Box Corporation, et al.* (Civil Action No. 09-CV-1591, W.D. PA). On December 8, 2009, the court entered an order permanently enjoining Baird, by consent, from future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, and Section 13(b)(5) of the Exchange Act, 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. Baird was also ordered to pay $87,243 in disgorgement and $31,402 in prejudgment interest.

4. The Commission's complaint alleged, among other things, that, while she was the Chief Financial Officer of Black Box, Baird participated in backdating stock options purportedly issued in October 2000 as part of a plan to reduce expenses. The complaint alleged that Baird knew or should have known that Black Box had failed to properly record compensation expenses for these options, which were granted at below market prices and were, therefore, "in the money." The complaint further alleged that Baird knew or should have known that Black Box's filings with the Commission, specifically the Form 10-Q for the quarter ending December 31, 2000 and the Form 10-K for the year ending March 31, 2001 contained materially false and misleading statements. The complaint also alleged that Baird failed to implement a system of internal accounting controls to accurately reflect the granting of stock options, and aided and abetted Black Box's violations of the company's books and records and internal accounting controls requirements as they pertained to the administration and implementation of its stock option programs.

IV.

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

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

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

B. After five years from the date of this order, Respondent may request that the Commission consider her reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in her practice before the Commission will be reviewed either by the independent audit committee of the public company for which she works or in some other acceptable manner, as long as she practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Respondent, or the public accounting firm with which she is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which she is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the Respondent's or the firm's quality control system that would indicate that the Respondent will not receive appropriate supervision;

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

(d) Respondent acknowledges her responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

C. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that her state CPA license is current and she has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

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Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61247 / December 29, 2009

INVESTMENT ADVISERS ACT OF 1940
Release No. 2967 / December 29, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13731

In the Matter of Jeffrey C. Young, Respondent.	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(f) 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 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 Jeffrey C. Young ("Young" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings, Making Findings, and Imposing Remedial Sanctions Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940 ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

Summary

These proceedings arise out of Young's failure to supervise Harold Jaschke, a registered representative who, between May 2006 and March 2008, executed unauthorized transactions, made unsuitable recommendations, and churned his customers' accounts. During this time, Jaschke was associated with First Allied Securities, Inc. ("First Allied"), a registered broker-dealer for which Young was the vice president of supervision. Jaschke violated Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by engaging in an unauthorized high risk, short term Treasury bond trading strategy on behalf of his customers. Jaschke's customers, the City of Kissimmee ("COK") and the Tohopekaliga Water Authority ("Toho") (collectively, the "Municipalities"), were required by ordinance to invest their funds in order to provide for safety of capital, liquidity of funds, and investment income, in that order of importance, and were prohibited specifically from using the proceeds of repurchase agreements and reverse repurchase agreements for the purpose of making investments. Despite being aware of the ordinances, Jaschke engaged in a high risk trading strategy and leveraged the Municipalities' accounts in violation of the ordinances. In addition, Jaschke lied to the Municipalities to conceal the risky nature of the investments, his use of leverage, and large unrealized losses the accounts experienced as a result of his misconduct.

Young failed reasonably to supervise Jaschke because he failed to respond adequately to "red flags" relating to Jaschke and failed to take reasonable steps to ensure that First Allied's procedures regarding suitability were followed. Young received notices generated by Bear, Stearns Securities Corp. ("Bear Stearns"), First Allied's clearing broker, that highlighted declining equity and high turnover in the Municipalities' accounts. However, Young did not contact the Municipalities to discuss the account activity. In addition, Young was aware that Jaschke claimed that the Bear Stearns account statements were inaccurate and that Jaschke provided the Municipalities with his own trading spreadsheets. While Young himself did not understand Jaschke's spreadsheets and, in fact, questioned the accuracy of the information contained therein, Young did not ensure that the spreadsheets were accurate, despite knowing that they were being provided to the Municipalities. Finally, Young failed to follow First Allied's procedures regarding suitability determinations. As a result, Young failed reasonably to supervise Jaschke within the meaning of Section (15)(b)(6)(A) of the Exchange Act which incorporates by reference Section 15(b)(4)(E) and Section 203(e)(6) of the Advisers Act.

Respondent

1. **Jeffrey C. Young ("Young"),** age 45, resides in San Diego, California. Young has been associated with First Allied since 1997. From 2000 to August 2009, he was vice president of supervision. He is currently vice president of special projects.

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

Other Relevant Entities and Persons

2. **First Allied Securities, Inc. ("First Allied")** is a New York corporation with its principal place of business in San Diego, California. Since 1993, First Allied has been registered with the Commission as a broker-dealer, and, since 1994, as an investment adviser. First Allied licenses over 900 independent contractor representatives and maintains approximately 600 branch offices nationwide. First Allied is solely owned by FAS Holdings Inc., which in turn is solely owned by Advanced Equities Financial Corp.

3. **Harold H. Jaschke ("Jaschke"),** age 48, resides in Houston, Texas. Jaschke was associated with First Allied as a registered representative from June 2005 until August 2008, at which time First Allied terminated its association with Jaschke.

Background

4. Jaschke recommended that the Municipalities engage in a trading strategy involving long-term, zero-coupon United States Treasury Bonds, also known as "STRIPS" (which stands for Separate Trading of Registered Interest and Principal of Securities). Jaschke's strategy involved buying and selling the same STRIPS within a matter of days, and sometimes within the same day, to take advantage of short term changes in the price of STRIPS. In addition to simply short-term trading in STRIPS, Jaschke used repurchase agreements, or "repos," to finance purchases of STRIPS for the Municipalities. Repos are agreements in which a seller of securities agrees to buy the securities back from the purchaser at a specified price at a designated future date. In other words, repos are a type of short- term loan, which in this case were collateralized by STRIPS. The use of repos significantly increased the risks to which Jaschke's customers were exposed, as repos effectively allowed the accounts to borrow large amounts of money in order to hold larger positions of STRIPS. As a result of Jaschke's trading strategy, between May 2006 and June 2007, COK's account value declined 56% and Toho's account value declined 58%, an aggregate unrealized loss of more than $47 million. The Municipalities closed their accounts in March 2008 at a profit.

5. The individuals responsible for making investment decisions on behalf of the Municipalities relied upon Jaschke for information regarding their investments in STRIPS. They also relied on Jaschke to ensure that any investing they engaged in complied with their investment policies, which were substantially identical, and codified in municipal ordinances. The ordinances stated, among other things, that the Municipalities' funds were to be invested to provide safety of capital, liquidity of funds, and investment income, in that order of importance. The ordinances, while allowing for the use of repos for liquidity, also specifically prohibited using repos for the purpose of making investments. Despite these restrictions, Jaschke engaged in risky trading and used repos in a manner that directly violated the terms of the Municipalities' investment ordinances.

Jaschke's Material Misrepresentations and Omissions

6. Jaschke lied to the Municipalities regarding his use of leverage in their accounts. In fall 2006, the STRIPS market fell, causing Jaschke to significantly leverage the Municipalities' accounts to allow him to continue his trading strategy. This, in turn, caused the

percentage of equity in the Municipalities' accounts to drop below Bear Stearns' equity threshold. As a result, the accounts began receiving house calls that required an infusion of cash to meet the required equity percentage. House calls could be satisfied by either wiring cash into the account, or by selling off securities.

7. Jaschke lied to the Municipalities about the house calls' existence. He instructed his customers to ignore communications on First Allied letterhead regarding the need to make deposits to cover the house calls. When Jaschke needed additional funds wired into one of the accounts to satisfy a house call, he contacted his customers purporting to offer them new STRIPS "investments," which typically involved an investment of a fixed amount that would be returned shortly with a specific rate of return. However, instead of investing his customers' funds as promised, Jaschke simply used the "investment" funds to meet house calls, then returned the funds plus the rate of return when the accounts no longer needed the cash to meet the required equity threshold. If the Municipalities weren't interested in making these "investments," or if Jaschke chose not to approach them, he would simply direct First Allied's margin clerks to sell securities to cover the calls without ever disclosing either the house call or the sale to his customers (although the Municipalities did receive trade confirmations).

8. Jaschke also lied to the Municipalities regarding their account activity and performance. Between December 2006 and June 2007, the Municipalities' accounts continuously lost value, and experienced extremely large, unrealized losses by the summer of 2007 when the STRIPS market rapidly declined. Jaschke never disclosed the unrealized losses to his customers. Although the Municipalities received account statements from Bear Stearns, Jaschke instructed them to ignore those statements. For example, when one customer noticed that Toho's account statement showed losses in December 2006, Jaschke told him that the statements were inaccurate due to problems with Bear Stearns' systems, and instructed him to instead rely on spreadsheets Jaschke had prepared. On at least one of Jaschke's spreadsheets, the market value of Toho's STRIPS was overstated by approximately $25 million.

9. In late summer 2007, COK's and Toho's auditors began reviewing the Municipalities' investment activity and identified the unrealized losses. Jaschke blamed the losses on Bear Stearns and falsely claimed that the accounts had mistakenly been treated as margin accounts and were wrongfully liquidated, at a loss, to cover margin calls. In reality, Bear Stearns neither liquidated the Municipalities' accounts, nor directed anyone at First Allied to do so. Instead, the losses resulted from Jaschke's trading in the accounts while the STRIPS market suffered a dramatic decline, and Jaschke simply lied to deflect attention from his unauthorized activities.

<u>Jaschke's Unauthorized Trading</u>

10. Between May 2006 and March 2008, Jaschke engaged in several different types of unauthorized trading in the Municipalities' accounts. Despite the fact that the Municipalities held non-discretionary accounts with First Allied, Jaschke conducted hundreds of short-term STRIPS transactions in the Municipalities' accounts without the full knowledge or authorization of his customers.

11. Additionally, Jaschke's use of repos was unauthorized. Jaschke led the Municipalities to believe that the repos were used only to facilitate the transfer of funds between the Municipalities and First Allied, and would not be used to leverage the Municipalities' investment portfolios. Despite his statements to his customers, Jaschke continually used repos to highly leverage both accounts.

12. Finally, Jaschke conducted unauthorized transactions to hide the numerous house calls the Municipalities received. Jaschke engaged in unauthorized sales of securities to meet some house calls, and lied to his customers about non-existent investment opportunities in order to secure funds to satisfy other house calls.

Jaschke's Unsuitable Recommendations

13. Jaschke's trading strategy was unsuitable for the Municipalities in light of their investment ordinances and their conservative investment objectives. Their investment ordinances prioritized safety of capital above all else, and specifically prohibited using repos for the purpose of making investments. Jaschke was aware of, and had copies of, the Municipalities' investment ordinances, and the accounts were listed as having low or moderate risk tolerances within First Allied's internal account-tracking system. Nevertheless, Jaschke embarked on a risky trading strategy that involved short-term trading, a practice described as "trading" in First Allied's written definitions of investment objectives, which was not appropriate for customers with a low investment risk tolerance. Additionally, Jaschke used repos to invest in STRIPS, a practice he knew was specifically prohibited by the Municipalities' investment ordinances.

Jaschke's Churning

14. Between May 2006 and March 2008, although COK's and Toho's accounts were set up as non-discretionary, Jaschke engaged in unauthorized trading and/or in effect had complete discretion over the accounts at all relevant times. Jaschke excessively traded the Municipalities' accounts for his own gain in disregard of his customers' interest.

Young's Failure to Supervise Jaschke

15. Young failed reasonably to supervise Jaschke. Young was the vice president of supervision and the head of First Allied's supervision department, a role that required him to oversee and train other supervisors regarding compliance with First Allied's policies and procedures. While Young was not Jaschke's direct supervisor, he became actively involved in supervising Jaschke in September 2006 and thereafter began making significant supervisory decisions regarding Jaschke's handling of the Municipalities' accounts. Young also had the powers traditionally associated with a supervisor, including the ability to discipline and fire Jaschke.

Young Failed to Respond Reasonably to Red Flags

16. Young was first notified of abnormal trading in the Municipalities' accounts in September 2006 when automated account surveillance reports, or "exception reports," generated by Bear Stearns were escalated to him. The exception reports showed turnover rates of 17 for

COK and 21 for Toho, and indicated the possibility of churning in the accounts.[2] When a valid exception report was generated, First Allied's general practice was to send its customers a "negative response letter," i.e., no response is required. The negative response letter informed the customer of the type of activity shown on the exception report and provided the customer with the contact information for the regional supervisor responsible for the account in the event the customer had questions.

17. However, when Young received the September 2006 exception reports for the Municipalities, he did not send them negative response letters. Young was concerned because institutional (rather than retail) customers were involved, and he had had little experience dealing with such customers and was unsure whether to send out the typical negative response letter or whether to take some other action. Because he believed, based on representations from Jaschke, that the Municipalities were sophisticated and that the trading in the accounts was occurring at their direction, Young worried that he would appear to be uninformed if First Allied were to send the customers negative response letters, since he assumed that they and Jaschke understood the activity in the accounts better than he did. Bear Stearns generated additional exception reports in December 2006 indicating turnover ratios of 301 for COK and 106 for Toho, and highlighting the fact that COK's account had underperformed the S&P by 40%. Young did not send negative response letters to the Municipalities with respect to these reports as well. Young's responses to the exception reports were inadequate, as they did not result in prompt follow up on red flags regarding churning and suitability.

18. Over the next few months, as the Municipalities' account equity continued to drop, Young became increasingly concerned about the activity in both accounts. In response, Young had numerous conversations with Jaschke, during which Jaschke provided various excuses for the volatile account activity, including the falsehood that Bear Stearns' automated system did not know how to treat repos, which supposedly caused the exception reports and inaccurate account statements to be generated. Young failed adequately to question the veracity of Jaschke's often detailed and convoluted explanations, partly because he did not understand Jaschke's complex underlying trading strategy.

19. Furthermore, Young asked Jaschke to provide him copies of the spreadsheets Jaschke supposedly kept to reconcile the account activity due to the purported complexity of Bear Stearns' account statements. After several initial delays, Jaschke finally produced the spreadsheets, but Young did not fully understand them. Young was told by Jaschke that Jaschke was providing these same spreadsheets to the Municipalities and, although concerned about their accuracy, Young did not take any other steps to ensure that the Municipalities were receiving accurate account information from Jaschke. Young's failure to respond to red flags regarding the accuracy of information provided to the customers by Jaschke was unreasonable, particularly given that he was also aware of other red flags regarding the same accounts.

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[2] A turnover rate measures the turnover in an account, which is the number of times during a given period that the securities are replaced by new securities, by dividing the total cost of purchases made during a given period by the average amount invested during that period. A turnover rate that exceeds six is presumptive of churning. Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 767 F.2d 1498, 1502 (11th Cir. 1985); In the Matter of Al Rizek, 1998 SEC LEXIS 905, at 52.

Young Failed to Assess Suitability in Accordance With Firm Policies

20. Despite the fact that he considered the Municipalities to be institutional investors, Young did not adequately assess the suitability of Jaschke's trading based on the firm's institutional investor suitability guidelines, which required consideration of the customer's ability to evaluate investment risk independently, and the extent to which the customer was exercising independent judgment regarding the transaction.

21. Additionally, First Allied's written supervisory procedures required Young to conduct reviews of exception reports. However, he failed to verify the accuracy of Jaschke's responses to the exception reports generated in September and December 2006. In February 2007, Jaschke submitted his responses to the December 2006 exception reports, falsely stating that the risk tolerance for the Municipalities was "high." Young knew that this was a change from prior account records he had reviewed. Those records were from 2003, and Young had asked Jaschke to have the Municipalities submit updated account documentation. However, Young did not check the firm's records to see if they had actually been updated, and did not check to see if any new paperwork had actually been submitted by the Municipalities. In fact, the Municipalities' account information was never changed within the firm's records and always showed a low or moderate risk tolerance because the Municipalities, by the terms of their investment ordinances, were required to engage only in conservative trading. If Young had checked the firm's internal systems, he would have seen that the Municipalities were listed as having low or moderate risk tolerances, and likely could have detected or prevented Jaschke's fraud.

22. Young's failure to follow the firm's established procedures was especially unreasonable because he was the head of First Allied's supervision department and was responsible for overseeing and training other supervisors regarding compliance with the firm's policies and procedures.

Legal Analysis

23. As a result of the conduct described above, Jaschke violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

24. Section 15(b)(4)(E) of the Exchange Act requires broker-dealers reasonably to supervise persons subject to their supervision, with a view toward preventing violations of the federal securities laws. See, e.g., Dean Witter Reynolds, Inc., Exchange Act Rel. No. 46578 (October 1, 2002). The Commission has emphasized that the "responsibility of broker-dealers to supervise their employees by means of effective, established procedures is a critical component in the federal investor protection scheme regulating the securities markets." Id. Section 15(b)(4)(E) of the Exchange Act provides for the imposition of a sanction against a broker or dealer who "has failed reasonably to supervise, with a view to preventing violations of the securities laws, another person who commits such a violation, if such other person is subject to his supervision." Section 15(b)(6)(A)(i) incorporates by reference Section 15(b)(4)(E) and provides for the imposition of sanctions against persons associated with a broker-dealer. Similarly, Section 203(f) of the Advisers Act, incorporating by reference Section 203(e)(6) of the Advisers Act, authorizes the Commission to sanction a person who is associated, or at the time of

the alleged misconduct was associated, with an investment adviser for failing reasonably to supervise, with a view to preventing violations of the federal securities law, another person who commits such a violation, if that person is subject to the person's supervision.

25. As a result of the conduct described above, Young failed reasonably to supervise Jaschke within the meaning of Section 15(b)(4)(E) of the Exchange Act, and within the meaning of Section 203(f) of the Advisers Act, when he failed to supervise Jaschke with a view to preventing and detecting his violations of the federal securities laws.

IV.

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

Accordingly, pursuant to Section 15(b) of the Exchange Act and Section 203(f) of the Advisers Act, it is hereby ORDERED that:

A. Respondent Young be, and hereby is, suspended from association in a supervisory capacity with any broker, dealer or investment adviser for a period of nine (9) months.

B. IT IS FURTHER ORDERED that Respondent shall, within one year of the entry of this Order, pay a civil money penalty in the amount of $25,000 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 Young 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 Michele Wein Layne, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., Suite 1100, Los Angeles, CA 90036.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61252 / December 29, 2009

ADMINISTRATIVE PROCEEDING
FILE NO. 3-11530

In the Matter of

Banc One Investment Advisors Corporation and Mark A. Beeson,

Respondents.

ORDER DISCHARGING PLAN ADMINISTRATOR AND TERMINATING FAIR FUND

On June 29, 2004, Banc One Investment Advisors Corporation ("BOIA") consented to the entry of an 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, and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Order"), which directed, among other things, that BOIA pay disgorgement of $10 million and civil penalties of $40 million, for a total payment of $50 million, and established a Fair Fund to provide for the distribution of funds to investors harmed by the market-timing conduct described in the Order. The Order further directed that BOIA retain an Independent Distribution Consultant ("IDC") and require the IDC to "develop a Distribution Plan for the distribution of all of the disgorgement and penalties to be paid by BOIA pursuant to this Order, and any interest or earnings thereon, according to a methodology developed in consultation with BOIA and acceptable to the staff of the Commission and the independent Trustees of the One Group funds." BOIA retained Professor Joseph A. Grundfest as the IDC.

On August 7, 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. 34-54280). The Commission received comments and on May 9, 2007, the Modified Plan of Distribution ("Plan") was approved and Boston Financial Data Services, Inc. ("BFDS") was appointed as the Plan Administrator. The Plan provided for the distribution of the Fair Fund, according to an Allocation Algorithm described in the Plan, to investors who held shares in at least one of eleven of the One Group Mutual Funds in which market timing occurred, on the days on which the market timing occurred, between June 1999 and May 2003. The Plan further provided that any funds that could not be distributed to investors were to be distributed to the One Group

Mutual Funds using the Allocation Algorithm, and that any residual funds remaining after all distributions would be transferred to the U.S. Treasury.

On July 10, 2007, the Commission entered an order directing disbursement of the Fair Fund consisting of the $50,000,000 in disgorgement and civil penalties and $5,670,031.01 in accrued interest, for a total of $55,670,031.01. On or about August 10, 2007, BFDS began issuing checks or wires to a total of 210,779 investors. BFDS also made a distribution to the One Group Mutual Funds after the distributions to investors. After these distributions, $36,399.23 in residual funds remains.

The Plan Administrator submitted a Final Accounting pursuant to Rule 1105(f) of the Commission's Rules on Fair Fund and Disgorgement Plans, which was approved by the Commission. Pursuant to the Plan Administrator's Final Accounting, $36,399.23 in residual funds is to be transmitted to the U.S. Treasury.

Accordingly, IT IS ORDERED the Fair Fund is terminated.

IT IS FURTHER ORDERED THAT the Plan Administrator is discharged.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By: Florence E. Harmon
Deputy Secretary

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UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 61262 / December 30, 2009

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3092 / December 30, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13732

In the Matter of **STEPHEN C. GINGRICH (CPA)** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Stephen C. Gingrich ("Respondent" or "Gingrich") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings

[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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herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III. 3. below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Gingrich, age 41, possesses a certificate of certified public accountant ("CPA") in the Commonwealth of Pennsylvania. His license to practice has voluntarily been on inactive status since April 2002. He has been employed by Home Solutions of America, Inc. ("HSOA") since July 2006, and served as controller of its subsidiary Fireline Restoration, Inc. ("Fireline") from July 2006 through July 2008.

2. On November 30, 2009, the Commission filed a Complaint in the U.S. District Court for the Northern District of Texas in a civil action captioned Securities and Exchange Commission v. Home Solutions of America, Inc., et al., Civil Action Number 3:09-CV-02269-N. The Complaint named Gingrich as a defendant. As to Gingrich, the Complaint alleged that in connection with the preparation and audit of HSOA's financial statements for its year ended December 31, 2006, and preparation and review of HSOA's financial statements for its quarters ending March 31, 2007 and June 30, 2007, Gingrich (a) instructed Fireline employees to sign documents that materially misrepresented the progress of certain construction projects, and provided the documents to HSOA's auditor; and (b) at the direction of HSOA's chief financial officer, made accounting entries on Fireline's books and records that materially misrepresented HSOA's revenues.

3. On December 10, 2009, the District Court entered an agreed final judgment against Gingrich, permanently enjoining him from direct or indirect future violations of Sections 17(a)(2) and (3) of the Securities Act of 1933 and from aiding and abetting violations of Sections 13(a) and 13(b)(2)(A) of the Securities Exchange Act of 1934 and Rules 12b-20, 13a-1, and 13a-13 thereunder. Gingrich was also ordered to pay a civil penalty of $25,000. Gingrich consented to the entry of the final judgment without admitting or denying the allegations made in the Commission's Complaint.

IV.

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

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

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

B. After three years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Respondent, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the Respondent's or the firm's quality control system that would indicate that the Respondent will not receive appropriate supervision;

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

(d) Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

C. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependant on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy
Secretary

Florence E. Harmon

By Florence E. Harmon
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 275 and 279

[Release No. IA-2968; File No. S7-09-09]

RIN 3235-AK32

Custody of Funds or Securities of Clients by Investment Advisers

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting amendments to the custody and recordkeeping rules under the Investment Advisers Act of 1940 and related forms. The amendments are designed to provide additional safeguards under the Advisers Act when a registered adviser has custody of client funds or securities by requiring such an adviser, among other things: to undergo an annual surprise examination by an independent public accountant to verify client assets; to have the qualified custodian maintaining client funds and securities send account statements directly to the advisory clients; and unless client assets are maintained by an independent custodian (i.e., a custodian that is not the adviser itself or a related person), to obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board. Finally, the amended custody rule and forms will provide the Commission and the public with better information about the custodial practices of registered investment advisers.

DATES: Effective Date [Insert 60 days after publication in the Federal Register].

Compliance Dates: An investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010. An investment adviser also required to obtain or receive an internal control report because it or a related person maintains client assets as a qualified custodian must obtain or receive an internal control report within six months of the effective date. Section III of this Release contains additional information on the effective and compliance dates.

FOR FURTHER INFORMATION CONTACT: Vivien Liu, Senior Counsel, Melissa A. Roverts, Senior Counsel, Daniel S. Kahl, Branch Chief, or Sarah A. Bessin, Assistant Director, at (202) 551-6787 or <IArules@sec.gov>, Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is adopting amendments to rule 204-2 [17 CFR 275.204-2], rule 206(4)-2 [17 CFR 275.206(4)-2] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (the "Advisers Act" or "Act"), to Form ADV [17 CFR 279.1], and to Form ADV-E [17 CFR 279.8].

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I. BACKGROUND

Earlier this year we began a comprehensive review of our rules regarding the safekeeping of investor assets in connection with our bringing several fraud cases involving investment advisers and broker-dealers.[1] As part of this effort, we proposed amendments to rule 206(4)-2, the rule under the Advisers Act that governs an adviser's custody of client funds and securities ("client assets").[2] Our staff is currently reviewing potential recommendations to enhance the oversight of broker-dealer custody of customer

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1 Since the beginning of this year, the Commission has brought several enforcement actions against investment advisers and broker-dealers alleging fraudulent conduct, including misappropriation or other misuse of investor assets. See cases cited in footnote 11 of Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2876 (May 20, 2009) [74 FR 25354 (May 27, 2009)] (the "Proposing Release"). In addition to these actions, we have brought several others more recently alleging similar types of misconduct. See, e.g., In re Stratum Wealth Management, LLC and Charles B. Ganz, Advisers Act Release No. 2930 (Sept. 29, 2009)(settled action in which Commission alleged a registered investment adviser, through its sole owner and chairman, misappropriated over $400,000 from a client account during the course of nearly a year to pay for his personal expenses and falsified client account statements, among other things); SEC v. Titan Wealth Management, LLC, et al., Litigation Release No. 21184 (Aug. 26, 2009)(complaint alleges a registered investment adviser misappropriated 80% of investor funds for personal use, to make Ponzi payments to certain investors or transfers to others); In the Matter of Paul W. Oliver, Jr., Advisers Act Release No. 2903 (Jul. 17, 2009)(settled action in which Commission alleged a registered investment adviser's chairman aided and abetted misappropriations of more than $23 million in client funds by the investment adviser's co-founder and president); SEC v. Weitzman, Litigation Release No. 21078 (June 10, 2009)(settled action in which Commission's complaint alleged registered investment adviser's co-founder and principal stole more than $6 million in investor funds for his own personal use and falsified client account statements). See also SEC v. Frederick J. Barton, Barton Asset Management, LLC, and TwinSpan Capital Management, LLC, Litigation Release No. 21016 (Apr. 29, 2009)(default judgment entered against registered investment adviser and its direct and indirect majority owner for diverting approximately $493,100 of offering proceeds for personal use and for misappropriating $685,000 from one advisory client and $970,000 from another); SEC v. Crossroads Financial Planning, Inc., et al., Litigation Release No. 20996 (Apr. 10, 2009)(complaint alleges registered investment adviser, through its president, chief operating officer and principal owner, misappropriated at least $2.3 million of client assets).

2 We use the term "client assets" solely for ease of reference in this Release; it does not modify the scope of client funds or securities subject to the rule.

assets. Thus today's adoption represents a first step in the effort to enhance custody protections, with consideration of additional enhancements of the rules governing custody of customer assets by broker-dealers to follow.

The amendments we proposed earlier this year to rule 206(4)-2 were designed to strengthen the existing custodial controls imposed by the rule. Under rule 206(4)-2, advisers, in most cases, must maintain client funds and securities with a "qualified custodian."[3] Qualified custodians under the rule include the types of financial institutions to which clients and advisers customarily turn for custodial services, including banks, registered broker-dealers, and registered futures commission merchants.[4] These institutions' custodial activities are subject to regulation and oversight.[5] In addition, advisers must have a reasonable belief that the qualified custodian sends account statements directly to advisory clients.[6] The rule also permits advisers (rather than custodians) to send account statements if the adviser is subject to an annual surprise verification of client assets by an independent public accountant.[7]

The proposed amendments were designed to eliminate certain exemptions in the rule, thus expanding the protections afforded advisory clients by requiring all registered advisers with custody of client assets to be subject to an annual surprise examination,[8] and requiring that they have a reasonable belief that qualified custodians send account

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3 Rule 206(4)-2(a)(1).

4 Rule 206(4)-2(c)(3).

5 See Proposing Release, at note 4.

6 Rule 206(4)-2(a)(3)(i).

7 Rule 206(4)-2(a)(3)(ii).

8 Proposed rule 206(4)-2(a)(4).

statements directly to the clients.[9] When the adviser or its related person serves as qualified custodian for client assets, the proposed amendments would require that the adviser undergo an annual surprise examination and obtain, or receive from the related person, an internal control report with respect to custody controls, both of which must be performed or prepared by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB").[10] Amendments to Form ADV would require advisers to report current information to us about these custodial arrangements.

We received more than 1,300 comment letters on the proposed amendments. Most were from investment advisers, broker-dealers, banks, and their trade associations that would be affected by the amended rule and which objected to significant parts of our rulemaking initiative.[11] Commenters generally expressed their support for our goal of strengthening protections provided to advisory clients under the custody rule. Most urged us to make changes to our proposal particularly as it applies to advisers that have custody solely because of their authority to deduct advisory fees from client accounts. Many suggested that we update our guidance on the elements of the annual surprise examination performed by an independent public accountant.[12]

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9 Proposed rule 206(4)-2(a)(3). The proposed amendments, however, would not eliminate an exception to the direct delivery requirement currently available to advisers to pooled investment vehicles that are subject to an annual audit and distribute the audited financial statements to investors in the pool. See proposed rule 206(4)-2(b)(3).

10 Proposed rule 206(4)-2(a)(6)(ii)(B).

11 Other commenters included accountants, law firms, consultants, and investors. Of the 1,300 letters, approximately 1,100 were form letters or substantially similar letters submitted by smaller advisory firms.

12 The comment letters are available for public inspection and photocopying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC (File No. S7-

II. Discussion

We are today adopting amendments to rule 206(4)-2 to strengthen controls over the custody of client assets by registered investment advisers and to encourage the use of independent custodians. We are also adopting related amendments to rule 204-2, Form ADV, and Form ADV-E that will improve our ability to oversee advisers' custody practices. In response to comments, we made several modifications from the proposal. In addition, we are today publishing a companion release to provide guidance for accountants with respect to the surprise examination and internal control report required under rule 206(4)-2.

We believe these amendments, together with the guidance for accountants, will provide for a more robust set of controls over client assets designed to prevent those assets from being lost, misused, misappropriated or subject to advisers' financial reverses. We acknowledge that no set of regulatory requirements we could adopt will prevent all fraudulent activities by advisers or custodians. We believe, however, that this rule, together with our examination program's increased focus on the safekeeping of client assets, will help deter fraudulent conduct, and increase the likelihood that fraudulent conduct will be detected earlier so that client losses will be minimized.

A. Delivery of Account Statements and Notice to Client

As discussed above, rule 206(4)-2 currently requires advisers that have custody, with certain limited exceptions, to maintain client funds or securities with a "qualified custodian," which the adviser must have a reasonable basis for believing sends an

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09-09). They are also available on our website at http://www.sec.gov/comments/s7-09-09/s70909.shtml.

account statement, at least quarterly, to each client for which the qualified custodian maintains funds or securities.[13] The requirement is designed so that advisory clients will receive a statement from the qualified custodian that they can compare with any statements (or other information) they receive from their adviser to determine whether account transactions, including deductions to pay advisory fees, are proper.[14]

We are adopting, as proposed, an amendment to the rule that eliminates an alternative to the requirement under which an adviser can send quarterly account statements to clients if it undergoes a surprise examination by an independent public accountant at least annually. We believe that direct delivery of account statements by qualified custodians will provide greater assurance of the integrity of account statements received by clients.

Most commenters that addressed this aspect of our proposal supported it as reflective of best practices followed by most advisers.[15] A few commenters objected to the proposal, suggesting that a client's desire for privacy may override the Commission's

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13 Rule 206(4)-2(a)(1). If the adviser is a general partner of a limited partnership or holds a similar position with another type of pooled investment vehicle, the account statement must be provided to the limited partners or other investors in the pooled investment vehicle. Rule 206(4)-2(a)(3)(iii). For convenience, we will presume in this Release that all advisers to pooled investment vehicles hold such a position.

14 Rule 206(4)-2(a)(3)(i). The rule provides an exception to this requirement for an adviser to a pooled investment vehicle if the pooled investment vehicle is audited annually by an independent public accountant and distributes the audited financial statements to the investors in the pool. See rule 206(4)-2(b)(3).

15 Comment letter of Compliance Solution Group (July 24, 2009)("CAS Letter"); comment letter of CFA Institute Centre for Financial Market Integrity (Dec. 11, 2009)("CFA Institute Letter"); comment letter from The Cornell Securities Law Clinic (July 28, 2009)("Cornell Letter"); comment letter from E*Trade Financial Corp. (July 28, 2009)("E*Trade Letter"); comment letter from Investment Adviser Association (July 24, 2009)("IAA Letter"); comment letter from North American Securities Administrators Association, Inc. (Aug. 5, 2009)("NASAA Letter"); comment letter from National Regulatory Services (July 28, 2009)("NRS Letter"); comment letter from Timothy P. Turner (July 27, 2009)("Turner Letter").

goal of investor protection.[16] In light of recent frauds, we believe generally that the protections provided by direct delivery of account statements by custodians are of substantially greater value than the privacy and confidentiality concerns that led us to permit this alternative.[17] Privacy concerns can be addressed through custodial contracts, or other agreements that restrict the custodian's use of confidential information, as one commenter suggested.[18]

As proposed, the amended rule requires that an adviser's reasonable belief that the qualified custodian sends account statements directly to clients must be formed by the adviser after "due inquiry."[19] We are not prescribing a single method for forming this belief, as was suggested by one commenter,[20] but rather are providing advisers with flexibility to determine how best to meet this requirement. For instance, an adviser could

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16 Comment letter from American Bar Association (Committee on Federal Regulation of Securities)(July 28, 2009)("ABA Letter"); NRS Letter; comment letter from The Private Equity Council (July 28, 2009)("PEC Letter").

17 See Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176 (Sept. 25, 2003)[68 FR 56692 (Oct. 1, 2003)] ("2003 Adopting Release"), at Section II.C. Qualified custodians may use service providers to deliver their account statements. The rule does not prohibit this practice, so long as the statements are sent to the client directly and not through the adviser. See 2003 Adopting Release at n.30.

18 See IAA Letter. In support of its assertion that that a client's desire for privacy could override the Commission's goal of investor protection, the ABA argued that contractual or other alternative means of protecting confidentiality would be insufficient and potentially very costly, although they did not provide support for these assertions. We note, in addition to contractual protections, other privacy protections are relevant in this context. As discussed in the Proposing Release at n.60, a U.S. qualified custodian would, with respect to individual clients who obtain custodial services for their personal, family or household purposes, be subject to the limitations on information sharing in the privacy rules adopted pursuant to Title V of the Gramm-Leach-Bliley Act. See e.g., 12 CFR Parts 40, 216, 332, 573 (privacy rules adopted by the Office of the Comptroller of the Currency, the Federal Reserve Board, the Office of Thrift Supervision, and the National Credit Union Administration); 17 CFR Parts 160, 248 (privacy rules adopted by the Commodity Futures Trading Commission and the SEC).

19 Amended rule 206(4)-2(a)(3).

20 Comment letter of Fifth Third Asset Management, Inc. (July 28, 2009)("FTAM Letter").

form a reasonable belief after "due inquiry" if the qualified custodian provides the adviser with a copy of the account statement that was delivered to the client.[21]

Rule 206(4)-2 requires investment advisers to notify their clients promptly upon opening a custodial account on their behalf and when there are changes to the information required in that notification.[22] We are amending the rule, as proposed, to require advisers to include a legend in the notice urging clients to compare the account statements they receive from the custodian with those they receive from the adviser.[23] Several commenters asserted that advisers may not (and are not required by rule 206(4)-2 to) send statements separate from the ones the custodian delivers and thus the proposed disclosure could confuse clients.[24] We agree and have, therefore, modified this notice requirement so that the cautionary legend must be included only if the adviser elects to send its own account statements to clients.[25] Finally, we had requested comment on whether to require

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21 This practice is followed by many advisers today. Commenters suggested that we permit advisers to satisfy the requirement of forming a reasonable belief after "due inquiry" by accessing qualified custodian account statements through the custodian's website. See comment letter from Curian Capital LLC, Financial Wealth Management, Inc, LPL Financial Corporation, and SEI Investments Company (July 28, 2009)("Curian Letter"). We believe that accessing account statements through the website merely confirms that they are available. If an adviser does not take additional steps to determine whether account statements were sent to clients, or that clients obtained statements through the website, the adviser would have an inadequate basis for forming a reasonable belief, after due inquiry, that the qualified custodian sends account statements to clients.

22 Rule 206(4)-2(a)(2).

23 Proposed rule 206(4)-2(a)(2). One commenter suggested not only requiring the legend in the initial notice, as proposed, but also adding a requirement to include the legend as an annual reminder in the annual Form ADV delivery offer or in the annual privacy statement. See comment letter of The National Association of Personal Financial Advisors (July 21, 2009)("NAPFA Letter"). We would not discourage advisers from adopting such a practice. As described above, we are adopting a regular notice requirement today for advisers.

24 CAS Letter; comment letter from Dechert LLP (July 28, 2009)("Dechert Letter"); IAA Letter; comment letter from MarketCounsel, LLC (July 28,2009)("MarketCounsel Letter"); NRS Letter.

25 Amended rule 206(4)-2(a)(2).

advisers who choose to send statements to also include in those statements the cautionary legend urging clients to compare the information the adviser sends to clients with the information reflected in the qualified custodian's account statements.[26] We believe providing regular notice will serve to more effectively remind clients to take steps to protect their assets. Accordingly, we are amending the rule to require those investment advisers, in any subsequent statements they deliver to clients after the initial notice, to urge clients to compare the adviser's statements with the account statements they receive from the custodian.[27]

B. Annual Surprise Examination of Client Assets

The Commission is adopting the proposed amendment to rule 206(4)-2 to require registered advisers with custody of client assets to undergo a surprise examination (or an audit, if applicable) of those assets by an independent public accountant, except as discussed below.[28] We are also adopting several amendments to the custody rule and related forms that will strengthen the utility of the surprise examination as a means of deterring misuse of client assets and will improve our ability to identify potential misuse of those assets. We are revising the guidance we provide to accountants that are engaged to perform these examinations in order to modernize the surprise examination and make it more effective. We believe these changes, discussed below, will improve protection of client assets.

1. Applicability of Surprise Examination

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26 See Proposing Release, at Section II.C. We did not receive comment on this particular approach.

27 Amended rule 206(4)-2(a)(2).

28 Amended rule 206(4)-2(a)(4).

We proposed to require that all advisers with custody obtain a surprise examination of client assets by an independent public accountant in order to provide "another set of eyes" on client assets, and thus an additional set of protections against their misappropriation. Because advisers with custody often have authority to access, obtain and, potentially, misuse client funds or securities, we believed the additional review provided by an independent public accountant would help identify problems that clients may not, and thus would provide deterrence against fraudulent conduct by advisers.[29]

Many commenters opposed the surprise examination requirement, arguing that it would provide little additional protection to client assets when assets are held with an independent qualified custodian that sends account statements directly to clients.[30] Almost all advisers that commented raised concerns about the high costs of the surprise examination and many asserted that the costs could drive smaller advisers that typically

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29 Some commenters agreed and expressed support of this proposal. See comment letter of Ascendant Compliance Management (July 27, 2009)(expressing support with respect to advisers that are registered as broker-dealers ("dual registrants")); CFA Institute Letter; comment letter of CLS Investments, LLC (July 28, 2009)("CLS Letter")(expressing support with respect to dual registrants); comment letter of The Consortium (July 18, 2009) ("Consortium Letter")(supporting the requirement other than for advisers who have custody solely because of their authority to deduct advisory fees from client accounts); comment letter of First Manhattan Co. (July 28, 2009)("FMC Letter")(expressing support with respect to dual registrants); NASAA Letter.

30 See, e.g., ABA Letter; comment letter of Advisor Solution Group (July 28, 2009)("ASG Letter"); comment letter of Davis Polk & Wardwell LLP (July 28, 2009)("Davis Polk Letter"); comment letter of Grandfield & Dodd, LLC (July 28, 2009)("G&D Letter"); Form Letter F; comment letter of Financial Planning Association (July 28, 2009)("FPA Letter"); IAA Letter; comment letter of Jackson, Grant Investment Advisers, Inc. (July 28, 2009)("Jackson Letter"); MarketCounsel Letter; NRS Letter; comment letter of Pickard and Djinis LLP (July 28, 2009)("Pickard Letter"); comment letter of SIFMA Asset Management Group (July 28, 2009)("SIFMA(AMG) Letter").

have custody only because of authority to deduct advisory fees out of business,[31] or, with respect to advisers that serve in capacities such as trustee on a limited basis, would cause them to cease providing such services to their clients.[32]

The focus of most commenters, however, was not on the utility of the surprise examination, but whether the proposed requirement should apply to certain advisers and advisory accounts, which we address below.[33] Some urged that if we expand the surprise examination requirement, we should update our guidance to accountants on examination methodology, which dates back to 1966 and requires verification of all client assets, a potentially expensive procedure not required in most audits.[34]

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31 See, e.g., comment letter of TD Ameritrade, Inc. (July 24, 2009) ("Ameritrade Letter"); CAS Letter; Cornell Letter; comment letter of Ronald P. Denk (July 3, 2009) ("Denk Letter"); comment letter of Janet Elder (July 1, 2009); Form Letter D; comment letter of Financial Services Institute (July 28, 2009) ("FSI Letter"); G&D Letter; comment letter of Thomas Hamilton (July 23, 2009); IAA letter; comment letter of The International Association of Small Broker Dealers and Advisors (May 27, 2009) ("IASBDA Letter"); comment letter of Carol K. Lampe (July 1, 2009); comment letter of Walter Marbert (July 1, 2009); comment letter of Scott A. McCord (July 1, 2009); NAPFA Letter; comment letter of Don Slabaugh (July 1, 2009); comment letter of Jeff Toadvine (July 1, 2009); comment letter of Anthony W. Welch (July 1, 2009).

32 See infra note 38.

33 Most commenters urged us to except advisers that have custody solely because of deducting advisory fees from the surprise examination requirement. See, e.g., ASG Letter; comment letter of Certified Financial Planner Board of Standards, Inc. (July 28, 2009)("CFP Board Letter"); comment letter of Center for Capital Markets Competitiveness, Chamber of Commerce (July 28, 2009)("Chamber of Commerce Letter"); Curian Letter; Dechert Letter; E*Trade Letter; comment letter of GE Asset Management (July 24, 2009)("GE Asset Letter"); G&D Letter; Form Letters B, F, and G; FPA Letter; IAA Letter; Jackson Letter; comment letter of The Money Management Institute (July 28, 2009)("MMI Letter"); NRS Letter; SIFMA(AMG) Letter; comment letter of SIFMA Private Client Legal Committee (July 28, 2009)("SIFMA(PCLC) Letter"); comment letter of Warshaw Burstein Cohen Schlesinger & Kuh, LLP (July 24, 2009)("Warshaw Letter").

34 Comment letter of The American Institute of Certified Public Accountants (July 28, 2009)("AICPA Letter); comment letter of Center for Audit Quality (July 28, 2009)("CAQ Letter"); Chamber of Commerce Letter; comment letter of Cohen Fund Audit Services, Ltd. (July 21, 2009) ("Cohen Letter"); Curian Letter; comment letter of Deloitte & Touche LLP (July 28, 2009)("Deloitte Letter"); comment letter of Ernst & Young (July 28, 2009)("E&Y Letter"); FPA Letter; FTAM Letter; comment letter of

We believe the surprise examination requirement will deter fraudulent conduct by investment advisers, and that it provides important protections to advisory clients, even when their assets are maintained by an independent qualified custodian.[35] If fraud does occur, a surprise examination will increase the likelihood that it is uncovered and thus reduce client losses.[36] Therefore, we are requiring advisers with custody of client assets to obtain a surprise examination (or an audit, if applicable in the case of a pooled investment vehicle) of client assets by an independent public accountant, other than as discussed below.[37]

We acknowledge the concerns raised by commenters with respect to the impact of the surprise examination requirement on smaller advisers whose client assets are maintained by an independent qualified custodian. For this reason, we have directed our

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KPMG LLP (July 28, 2009)("KPMG Letter"); comment letter of Managed Fund Association (July 28, 2009)("MFA Letter"); MMI Letter; comment letter of McGladrey & Pullen LLP (July 28, 2009)("M&P Letter"); comment letter of PricewaterhouseCoopers LLP (July 28, 2009)("PWC Letter"); comment letter of Charles Schwab (July 28, 2009)("Schwab Letter"); SIFMA(AMG) Letter; SIFMA(PCLC) Letter.

35 We have recently brought enforcement cases in which we alleged advisers misappropriated client assets that were maintained by an independent qualified custodian. See In re Stratum Wealth Management, LLC and Charles B. Ganz, Advisers Act Release No. 2930 (Sept. 29, 2009); In the Matter of Paul W. Oliver, Jr., Advisers Act Release No. 2903 (Jul. 17, 2009); SEC v. Weitzman, Litigation Release No. 21078 (June 10, 2009); SEC v. Crossroads Financial Planning, Inc., et al., Litigation Release No. 20996 (Apr. 10, 2009).

36 Under the amended rule, the independent public accountant conducting a surprise examination will verify client funds and securities of which an adviser has custody, including those maintained with a qualified custodian and those that are not required to be maintained with a qualified custodian, such as certain privately offered securities and mutual fund shares.

37 Amended rule 206(4)-2(a)(4). An investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010 or, for advisers that become subject to the rule after the effective date, within six months of becoming subject to the requirement. If the adviser itself maintains client assets as qualified custodian, however, the agreement must provide for the first surprise

staff to evaluate the impact of the surprise examination requirement on smaller advisers that have the authority to obtain possession of client funds or securities and whose client assets are maintained by an independent qualified custodian. We have also asked the staff to evaluate the impact of the surprise exam on these advisers' clients. Following the completion of the first round of surprise examinations of these advisers under the requirements of the amended rule, our staff will conduct a review and provide the Commission with the results of this review, along with any recommendations for amendments necessary to improve the effectiveness of the rule as it applies to these advisers, or address unnecessary burdens on them.

a. Advisers with Limited Custody Due to Fee Deduction

Commenters have persuaded us that the surprise examination will not provide materially greater protection to advisory clients when the adviser has custody of client assets solely because of its authority to deduct advisory fees from client accounts.[38] The principal risk associated with this limited form of custody is that a fee will be deducted to

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examination to occur no later than six months after obtaining the internal control report. See infra Section III.B.1.

38 Amended rule 206(4)-2(b)(3). This exception would also be available to such an adviser when the adviser can rely on amended rule 206(4)-2(b)(6). See infra Section II.C.2. of this Release. The exception would not be available, however, to an adviser that has custody under the rule for other reasons. Several commenters opposed applying the surprise examination requirement to advisers that serve as trustees for their clients. See comment letter of Allegheny Investments (July 28, 2009); Consortium Letter; G&D Letter; IAA Letter; NRS Letter; comment letter of Bruce Siegel (July 28, 2009). Some explained that most advisers that serve as trustees do so as a convenience to existing clients and either do not charge a separate fee or charge only a minimal fee for this service, and that requiring surprise examinations for these advisers will discourage advisers from serving as trustees and result in clients paying higher fees for this service. An adviser acting as trustee typically has significant authority over the assets in the trust, which would likely include the ability to access and, potentially, misuse those assets. We believe that the broad access that trustees typically have to trust assets makes the protections of the surprise examination important for these advisory clients to protect against potential abuse.

which the adviser is not entitled under the advisory contract. The amended rule addresses this risk by enabling the client to monitor the amount of advisory fees deducted by reviewing the account statement which, as discussed above, must be sent directly to the client by the qualified custodian.[39] Further, as several commenters noted the surprise examination may not be an effective tool to identify inappropriate fee deductions as it requires the accountant to verify client assets, not determine the accuracy of fees paid.[40] On balance, we believe that the magnitude of the risks of client losses from overcharging advisory fees does not warrant the costs of a obtaining a surprise examination. However, we do believe that appropriate controls should be in place regarding fee deduction, as discussed below.[41]

b. Pooled Investment Vehicle Audit

We proposed to require all registered investment advisers with custody of client assets to obtain an annual surprise examination, which included pooled investment vehicles subject to an annual financial statement audit. Several commenters asserted that a surprise examination would be duplicative of the annual financial statement audit and would not materially benefit investors.[42]

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39 Many commenters expressed similar views in their letters. See ASG Letter; CFP Board Letter; Dechert Letter; E*Trade Letter; FMC Letter; GE Asset Letter; G&D Letter; Form Letters B, F, and G; IAA Letter; Jackson Letter; MMI Letter; NRS Letter; SIFMA(AMG) Letter; SIFMA(PCLC) Letter; Warshaw Letter.

40 ABA Letter; Dechert Letter; FMC Letter; IAA Letter; MMI Letter; Pickard Letter; comment letter of Seward & Kissel LLP (July 29, 2009)("S&K Letter").

41 See infra notes 140 and 141 and accompanying text.

42 See comment letter of Adams Street Partners, LLC (July 28, 2009) ("Adams Street Letter"); Davis Polk Letter; Deloitte Letter; IAA Letter; MFA Letter; comment letter of The Bank of New York Mellon (July 28, 2009) ("Mellon Letter"); comment letter of National Society of Compliance Professionals, Inc. (July 28, 2009) ("NSCP Letter"); comment letter of National Venture Capital Association (July 28, 2009) ("NVCA Letter"); PEC Letter; SIFMA(AMG) Letter; S&K Letter; Warshaw Letter.

During the course of a financial statement audit, the accountant performs procedures comparable to those performed as part of a surprise examination, including verifying the existence of the pooled investment vehicle's funds and securities and obtaining confirmation from investors.[43] The financial statement audit also addresses additional matters important to pool investors that are not covered by the surprise examination, such as tests of valuations of pool investments, income, operating expenses, and, if applicable, incentive fees and allocations that accrue to the adviser.[44]

We believe that these and other procedures performed by the accountant during the course of a financial statement audit provide meaningful protections to investors, and that the surprise examination would not significantly add to these protections. Although the annual audit is not required to be performed at a time of the accountant's choosing (as is a surprise examination), we believe other elements of the audit incorporate an element of uncertainty similar to the surprise element of the surprise examination, with corresponding benefits to investors. Specifically, in the course of an annual audit, the auditor will select transactions to test during the period that the adviser will not be able to anticipate.

We have therefore amended the rule to deem an adviser to a pooled investment vehicle that is subject to an annual financial statement audit by an independent public accountant, and that distributes the audited financial statements prepared in accordance

43 See AICPA, Audit and Accounting Guide, Investment Companies, (May 1, 2009).

44 Id.

with generally accepted accounting principles to the pool's investors,[45] to have satisfied the annual surprise examination requirement ("annual audit provision").[46]

In addition, at the suggestion of several commenters,[47] we are limiting the rule's recognition of such audits as satisfying the surprise verification requirement to those audits performed by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.[48] We have greater confidence in the quality of such audits.[49]

We note that under rule 206(4)-2, an adviser to a pooled investment vehicle that distributes to its investors audited financial statements is not required to have a

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45 Amended rule 206(4)-2(b)(4)(i) requires that the audited financial statements be distributed within 120 days of the end of the pooled investment vehicle's fiscal year. In 2006, our staff issued a letter indicating that it would not recommend enforcement action to the Commission under section 206(4) of the Act or rule 206(4)-2 against an adviser of a fund of funds relying on the annual audit provision of rule 206(4)-2 if the audited financial statements of the fund of funds are distributed to investors in the fund of funds within 180 days of the end of its fiscal year. See ABA Committee on Private Investment Entities, SEC Staff Letter (Aug. 10, 2006). The amendments we are adopting today do not affect the views of the staff expressed in that letter.

46 Amended rule 206(4)-2(b)(4). We note that an adviser that relies on the annual audit provision must nonetheless undergo an annual surprise examination of non-pooled investment vehicle assets of which it has custody.

47 ABA Letter; Adams Street Letter; comment letter of Coalition of Private Investment Companies (July 31, 2009)("CPIC Letter"); MFA Letter.

48 Amended rule 206(4)-2(b)(4). The independent public accountant must be registered with, and subject to regular inspection by, the PCAOB as of the commencement of the professional engagement period, and as of each calendar year-end. Several commenters suggested other approaches, including enhancing the audit performed on the pool to include verification of securities (SIFMA(AMG) Letter), requiring an internal control report only instead of both the report and a surprise examination (ABA Letter; PEC Letter), and requiring several specific custody controls for advisers to pooled investment vehicles (CPIC Letter). We have considered the alternative approaches, some of which are beyond the scope of the proposal, and we believe, for the reasons discussed above, that our amendment to this aspect of the rule strikes the right balance.

49 See infra note 122 and accompanying text.

reasonable belief that a qualified custodian delivers account statements to investors.[50] As a consequence, investors in pooled investment vehicles do not have the benefit of regularly receiving reports that the assets underlying their investments are properly held. We are therefore concerned that the current protections of the rule may be insufficient, and we have directed our staff to explore ways in which we could remedy this potential shortcoming while respecting the confidential nature of proprietary information.

2. Commission Reporting

We are also adopting a number of rule and form amendments that will result in the Commission and the public receiving greater information about the custody practices of advisers and thus a greater ability to identify potential risks to clients. Under amended rule 206(4)-2, each investment adviser subject to the surprise examination requirement must enter into a written agreement with an independent public accountant to conduct the surprise examination. The agreement must require the accountant, among other things, to notify the Commission within one business day of finding any material discrepancy during the course of the examination, and to submit Form ADV-E to the Commission accompanied by the accountant's certificate within 120 days of the time chosen by the accountant for the surprise examination, stating that the accountant has examined the funds and securities and describing the nature and extent of the examination.[51] The agreement also must provide that, upon resignation or dismissal, the accountant must file

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[50] Rule 206(4)-2(b)(4).

[51] Amended rule 206(4)-2(a)(4)(i) and (ii). The written agreement will also require, in accordance with the current requirements of rule 206(4)-2, the independent public accountant to perform the surprise examination. Advisers must maintain copies of these written agreements under rule 204-2(a)(10). The obligation to maintain the records will apply for five years from the end of the fiscal year during which the last entry was made, the first two years in an appropriate office of the investment adviser. Rule 204-2(e)(1).

within four business days a statement regarding the termination along with Form ADV-E.[52] Accountants will file Form ADV-E with us electronically, through the Investment Adviser Registration Depository ("IARD").[53] We are adopting these amendments as proposed. The information they provide will assist the Commission's examination staff and the public in identifying risks raised by the investment adviser's custodial practices and in determining the frequency and scope of our staff's examination of an investment adviser.

The new requirement that accountants file Form ADV-E within 120 days of the time chosen by the accountant for the surprise examination is designed to require more timely completion of these examinations. Several commenters suggested that we extend the filing deadline to 180 days, asserting that more complex surprise examinations may take more time.[54] We note that these commenters' estimate of the duration of a surprise examination was based on the nature and extent of procedures contemplated under the existing guidance for accountants,[55] which many asserted was unnecessarily time consuming. As discussed more fully below, our revised guidance for accountants should

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52 Amended rule 206(4)-2(a)(4)(iii). The written agreement must require that the statement include (i) the date of such termination or removal, and the name, address, and contact information of the accountant, and (ii) an explanation of any problems relating to examination scope or procedure that contributed to such termination. Id. One commenter specifically expressed support for these time frames. CFA Institute Letter.

53 Until the IARD system is upgraded to accept Form ADV-E, accountants performing surprise examinations should continue paper filing of Form ADV-E. Advisers will be notified as soon as the IARD system can accept Form ADV-E.

54 IAA Letter; M&P Letter; PWC Letter. See also Dechert Letter; KPMG Letter; SIFMA(AMG) Letter (advocating for an extension, but not specifying that it be 180 days). One commenter suggested that we shorten it to 45-60 days. CFA Institute Letter.

55 Statement of the Commission describing nature of examination required to be made of all funds and securities held by an investment adviser and the content of related accountant's certificate, Accounting Series Release No. 103, Investment Advisers Act Release No. 201 (May 26, 1966) ("ASR No. 103").

address many of these concerns.[56] As a result, we believe that 120 days will be sufficient for an accountant to complete the examination.

Several commenters suggested we modify the requirement regarding the accountant's filing of a statement upon termination. Some argued that these filings should not be made available to the public,[57] that they should not be required if the accountant was terminated for innocuous reasons,[58] and that the adviser should have primary responsibility to report accountant dismissals, so that the accountant would submit a report only if the adviser failed to do so.[59] We have not revised the requirement in response to these comments. We believe it is important that the public have access to the termination statements to permit clients and prospective clients to assess for themselves the reasons for the termination of an accountant's engagement or an accountant's removal from consideration for being reappointed. Disclosure of a termination, even for apparently innocuous reasons, could provide useful information to advisory clients and to our staff. For example, identifying frequent changes in accountants could put clients and prospective clients on notice to inquire about the reasons for these events. Finally, while advisers are responsible for reporting accountant dismissals on Form ADV, the accountant's statement serves as an independent check on the adviser's filing and, as such, is important to increasing the effectiveness of the surprise examination requirement.

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[56] See Section II.B.4. of this Release.

[57] E*Trade Letter (arguing more broadly that no Form ADV-E filings should be made public, regardless of the reason for filing); IAA Letter; S&K Letter; Turner Letter.

[58] Davis Polk Letter; E*Trade Letter; IAA Letter.

[59] KPMG Letter.

3. Privately Offered Securities

We are adopting, as proposed, amendments to rule 206(4)-2 to no longer permit the accountant conducting the annual verification of client assets to forego examining certain privately offered securities, as defined in the rule.[60] As a result, advisers that maintain custody of privately offered securities on behalf of clients will be subject to the surprise examination requirement.[61]

Several commenters supported expanding the rule in this respect.[62] Others, however, asserted that the risk of fraud or misappropriation is low with respect to privately offered securities because they are not easily transferable, while the costs and practical difficulties of including these securities in a surprise exam may be considerable.[63] While privately offered securities may present little risk with respect to transferability, they present significant risks in other regards. First, it is difficult for

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60 The amended rule retains the current definition of "privately offered securities" as securities that are (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering, (ii) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client, and (iii) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. See amended rule 206(4)-2(b)(2).

61 We received various suggestions from commenters, some conflicting, regarding our approach to privately offered securities. See ABA Letter (suggesting that the Commission only subject privately offered securities held by the adviser or by related persons to surprise examinations, arguing that such a limitation would reduce costs and target the assets at greatest risk of misappropriation); MFA Letter (proposing that the Commission affirmatively state that some assets, such as bank loans and swaps, are not securities for purposes of rule 206(4)-2 and are, therefore, not subject to the rule). Others advocated expanding the annual verification requirement. See CPIC Letter (suggesting that the custody rule cover all assets held by private funds, not just securities and funds and proposing that all non-traditional assets should be held in the name of the custodian and all cash flows should be required to go through the custodian). We have considered the comments and, for the reasons discussed above, we believe our amendment to this aspect of the rule strikes the right balance with respect to privately offered securities.

62 ABA Letter; CFA Institute Letter; CPIC Letter; comment letter of The New York State Society of Certified Public Accountants (July 27, 2009).

63 Davis Polk Letter; MFA Letter; NVCA Letter; PWC Letter.

advisory clients to verify that these assets actually exist because ownership of such securities is recorded only on the issuers' books. Second, clients may have to rely on the information provided by the adviser to confirm their ownership of privately offered securities, as well as the existence of the underlying investment, when the adviser maintains custody of these securities.[64] Because clients are more dependent on the adviser with respect to the safeguarding of these securities, advisory clients may be exposed to additional risks when their advisers acquire these securities on their behalf. To mitigate these risks and to provide assurance that privately offered securities are properly safeguarded, we believe that it is appropriate to require an independent third-party to verify client ownership with the issuers of the securities by requiring that these securities be subject to the surprise examination requirement under the amended rule.[65]

It is our understanding that many accountants today do verify private securities in the course of a surprise examination, and several commenters requested that we provide guidance as to the procedures that an accountant should undertake with respect to the surprise examination of privately offered securities.[66] In our companion release, we

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64 Rule 206(4)-2 does not require advisers, with one limited exception, to maintain these assets with a qualified custodian because of the difficulties raised by recording ownership of the securities only on the books of the issuer. Rule 206(4)-2(b)(2). See also 2003 Adopting Release, at Section II.B.

65 Under amended rule 206(4)-2 an adviser may maintain custody of privately offered securities without being subject to the requirements that apply to advisers that maintain custody of client assets as qualified custodians set forth in paragraph (a)(6) of the rule, such as the internal control report, because the adviser need not be a qualified custodian to maintain custody of those securities. Amended rule 206(4)-2(b)(2). If, however, the adviser holding the privately offered securities also has custody of other client funds or securities as qualified custodian, the adviser is subject to the requirements set forth in paragraph (a)(6) of the rule.

66 MFA Letter; comment letter of The Association of Global Custodians (Aug. 03, 2009)("AGC Letter"); MarketCounsel Letter; comment letter of Sullivan & Cromwell (July 28, 2009).

provide guidance for accountants regarding conducting a surprise examination of client assets, including privately offered securities.[67]

4. Guidance for Accountants

In the Proposing Release, we requested that commenters address whether, and if so how, we should revise the guidance for accountants that we issued regarding the surprise examination.[68] Commenters that responded all generally agreed that our existing guidance, which we published in 1966, is inadequate because it neither reflects today's custodial practices nor adequately recognizes certain commonly accepted auditing practices.[69] In a companion release, we are providing updated guidance for accountants that addresses the surprise examination, as well as the internal control report required under amended rule 206(4)-2 and the relationship between them.[70] Our guidance discusses the relevant auditing and attestation standards that apply to these engagements, and, among other things, the nature and extent of the accountant's procedures with respect to the surprise examination. The revised guidance for accountants will modernize the procedures for the surprise examination.

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67 See infra note 70 and accompanying text. In the Proposing Release we requested comment on whether we should require the accountant performing the surprise examination to perform testing on the valuation of securities, including privately offered securities. One commenter stated that, although valuation is a very important issue closely related to client assets, it covers an area that goes beyond custody. Dechert Letter. We agree and are therefore not requiring accountants to perform testing of valuation as part of the surprise examination.

68 Proposing Release, at Section II.

69 AICPA Letter; CAQ Letter; Chamber of Commerce Letter; Cohen Letter; Curian Letter; Deloitte Letter; E&Y Letter; FTAM Letter; KPMG Letter; MFA Letter; MMI Letter; M&P Letter; PWC Letter; Schwab Letter; SIFMA(AMG) Letter; SIFMA(PCLC) Letter.

70 See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 2969 (Dec. 30, 2009) ("Accounting Release").

C. Custody by Adviser and Related Person

As amended, rule 206(4)-2 imposes additional requirements when advisory client assets are maintained by the adviser itself or by a related person rather than with an independent qualified custodian. As proposed, the amended rule requires, in addition to the surprise examination discussed above,[71] that when an adviser or its related person serves as a qualified custodian for advisory client funds or securities under the rule, the adviser obtain, or receive from its related person, no less frequently than once each calendar year, a written report, which includes an opinion from an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets ("internal control report"), such as a Type II SAS 70 report.[72] The amended rule also requires, in these circumstances, that the accountant issuing the internal control report, as well as the accountant performing the surprise examination, be registered with, and subject to regular inspection by, the PCAOB.[73] The adviser must maintain the

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71 See supra notes 28-37 and accompanying text. Several commenters asserted that the surprise examination would be duplicative of existing regulatory requirements (see, e.g., comment letter of American Bankers Association (July 28, 2009)("American Bankers Letter"); comment letter of LPL Financial (July 28, 2009) ("LPL Letter"); Mellon Letter; Schwab Letter; and SIFMA(PCLC) Letter). As we discuss later, the surprise examination requirement is important and not duplicative because it works in concert with the internal control report to protect advisory clients and because there are no existing regulatory requirements specifically focused on risks that may arise in the self or affiliated custody context. See infra notes 85-87 and accompanying text. Other commenters agreed that the surprise examination and internal control report are independently valuable and not duplicative (see E&Y Letter and NASAA Letter).

72 Amended rule 206(4)-2(a)(6)(ii). As discussed in more detail below, other types of reports could also satisfy the internal control report requirement. See infra notes 98-100 and accompanying text.

73 Amended rule 206(4)-2(a)(6)(i) and (ii)(C). The Commission's standards for the independence of accountants is set forth in Article 2, Rule 2-01 of Regulation S-X [17 CFR 210.2-01]. See 2003 Adopting Release at n.32. Article 2-01 does not preclude the accountant performing the surprise examination from also preparing the internal control report. The determination, however, of whether an accountant is independent under Article 2-01 includes consideration of all the relevant facts and circumstances.

internal control report in its records and make it available to the Commission staff upon request.[74]

1. Internal Control Report

Related person custody arrangements can present higher risks to advisory clients than maintaining assets with an independent custodian. As we pointed out in the Proposing Release, several of the recent enforcement actions in which we have alleged misappropriation of client assets have involved advisers or related persons that maintained client assets.[75] We requested comment on whether we should prohibit advisers from advising clients whose assets are maintained with the adviser or a related person.

Some commenters supported requiring an "independent" qualified custodian,[76] although many commenters opposed the requirement.[77] Several argued that use of an independent custodian would be an impractical requirement for many types of advisory accounts held by smaller investors with broker-dealers, such as wrap fee accounts, in which a client receives bundled advisory and brokerage services from a single firm (or

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74 Amended rule 204-2(a)(17)(iii).

75 See supra note 1.

76 See, e.g., NASAA Letter; comment letter of The National Association of Active Investment Managers (July 27, 2009)("NAAIM Letter"); NVCA Letter; comment letter of Kay Conheady (June 4, 2009); comment letter of Carol Y. Godsave (June 15, 2009); comment letter of Michael A. Pagano (June 26, 2009); comment letter of Robert J. Reed (June 1, 2009); comment letter of Robert N. Veres (June 27, 2009).

77 See, e.g., ABA Letter; AGC Letter; CLS Letter; Curian Letter; Davis Polk Letter; Dechert Letter; E*Trade Letter; FPA Letter; comment letter of Lincoln Investment (July 28, 2009); LPL Letter; comment letter of National Planning Holdings, Inc. (July 28, 2009) ("NPH Letter"); Pickard Letter; Schwab Letter; SIFMA(PCLC) Letter; comment letter of L.A. Schnase (July 3, 2009) ("Schnase Letter"); comment letter of State Street Corporation (July 28, 2009).

related firms) regulated as both an investment adviser and a broker-dealer.[78] It is common for institutional clients to maintain assets in a custodial account, often with a bank that is unaffiliated with the client's adviser. We are concerned, however, that requiring an independent custodian could make unavailable many advisory accounts popular with smaller investors, which are today maintained by the adviser or its affiliated brokerage firm or bank. Therefore, we are not amending the rule to require use of an independent custodian, although we encourage the use of custodians independent of the adviser to maintain client assets as a best practice whenever feasible.

To address the custodial risks associated with an affiliated custodial relationship, we proposed requiring, in addition to the surprise examination, an adviser to obtain, or receive from its related person, an annual internal control report, which would include an opinion from an independent public accountant with respect to the adviser's or related person's custody controls. We were concerned that the surprise examination alone would not adequately address custodial risks associated with self or related person custody because the independent public accountant seeking to verify client assets would rely, in part, on custodial reports issued by the adviser or the related person.

Several commenters expressed their support for the proposed internal control report requirement.[79] Two stated that our approach appropriately targets the frauds we are concerned about.[80] One large custodian urged us to require all qualified custodians to

78 ABA Letter; Curian Letter; Davis Polk Letter; E*Trade Letter; Pickard Letter; Schnase Letter; Schwab Letter; SIFMA(PCLC) Letter.

79 AICPA Letter; CFP Board Letter; Cornell Letter; comment letter of Diamant Asset Management, Inc. (July 20, 2009); E&Y Letter; FMC Letter; IAA Letter; NASAA Letter; NPH Letter; Pickard Letter; comment letter of T. Rowe Price Associates, Inc. (July 28, 2009)("T. Rowe Letter").

80 CFP Board Letter; IAA Letter.

obtain an internal control report.[81] Another agreed with our assessment that when the adviser or its related person acts as qualified custodian, there is increased risk to clients because the adviser may "misappropriate assets as a result of collusion with [its] affiliated custodians."[82] Other commenters, including those representing banks and broker-dealers, however, objected to the internal control report requirement, arguing that qualified custodians are already subject to extensive regulatory oversight and that the additional requirement would be duplicative of existing legal and regulatory requirements.[83] They argued that we would be imposing an unnecessary additional regulatory burden on affected custodians.

The internal control report requirement we are adopting today will provide important additional safeguards for client assets maintained with the adviser or a related person. As discussed in more detail below, the adviser must obtain or receive an internal control report that demonstrates that it, or its related person, has established appropriate custodial controls.[84] As we noted in the Proposing Release, the internal control report can significantly strengthen the utility of the surprise examination when the adviser or a related person acts as qualified custodian for client assets because it provides a basis for the independent public accountant performing the surprise examination to obtain additional comfort that the confirmations received from the related custodian are

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81 Schwab Letter.

82 ABA Letter.

83 LPL Letter; MMI Letter; NSCP Letter; comment letter of Pershing LLC (July 28, 2009) ("Pershing Letter"); SIFMA(PCLC) Letter; American Bankers Letter; comment letter of J.P. Morgan (Aug. 26, 2009).

84 Amended rule 206(4)-2(a)(6). An investment adviser subject to this requirement must obtain or receive an initial internal control report within six months of becoming subject to the requirement. See infra Section III.B.2. of this Release.

reliable.[85] The requirement to obtain an internal control report therefore serves both to inform the surprise examination process and may itself act as a deterrent to fraud by advisers that may consider misappropriating client assets directly or through a related person.[86]

We have carefully considered commenters' concerns about regulatory duplication in designing the internal control report requirement. We are adopting this requirement because there is no existing regulatory requirement applicable to investment advisers or other entities, such as broker-dealers and banks, that serve as qualified custodians that we believe is specifically focused on internal control risks that may arise in the affiliated custody context. We have, however, developed our guidance for accountants to permit accountants, when preparing an internal control report, to rely on their own relevant audit work performed for other purposes, including audit work performed to meet existing regulatory requirements, which should increase efficiencies in the audit process and help address commenters' concerns about duplication.[87]

We do not believe that the internal control report requirement will be unduly burdensome. A qualified custodian would only have to obtain an internal control report if it maintains the funds or securities of its own advisory clients or those of advisory clients of related persons. As one securities industry commenter noted, custodians often provide Type II SAS 70 reports to clients who demand a rigorous evaluation of internal

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85 Proposing Release, at Section II.B.2.

86 See id.

87 For example, accountants for broker-dealers perform a variety of procedures as part of a broker-dealer's financial statement audit and to satisfy related requirements under the Securities Exchange Act of 1934 ("Exchange Act"), including reconciliation procedures required for broker-dealers under the Exchange Act. See infra note 95.

control as a condition of obtaining their business.[88] A related person custodian therefore may be able to use a Type II SAS 70 report it is already obtaining and providing to other clients to satisfy the rule's requirement, and may also be able to use the same internal control report to satisfy the rule's requirement for several related advisers whose clients use the custodian.

The elements of the required internal control report are set forth in the companion release we are issuing today, which includes guidance for accountants regarding the overall objectives and scope of the internal control examination.[89] The internal control report must include the accountant's opinion as to whether the qualified custodian's internal controls have been placed in operation as of a specific date, and are suitably designed, and are operating effectively to meet control objectives related to custodial services, including the safeguarding of funds and securities of advisory clients during the year.[90] In order for the accountant to be able to form this opinion, the internal control report should address control objectives and associated controls related to the areas of client account setup and maintenance, authorization and processing of client transactions, security maintenance and setup, processing of income and corporate action transactions, reconciliation of funds and security positions to depositories and other unaffiliated custodians, and client reporting.[91]

We have revised the amended rule to state that, for the internal control report to satisfy the rule's requirements, the independent public accountant preparing the report

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88 SIFMA(AMG) Letter (noting that obtaining such a report is an "industry best practice").

89 See Accounting Release.

90 Amended rule 206(4)-2(a)(6)(ii)(A).

91 See Accounting Release.

must verify that the client funds and securities are reconciled to a custodian other than the adviser or its related person.[92] Reconciliation of custodial records to depositories is a key control objective of the internal control report, which will report on, among other things, tests of controls designed to meet this specific objective.[93] Internal control reports regarding custody, such as Type II SAS 70 reports, however, may not necessarily include specific procedures performed by the accountant that are designed to verify the reconciliation of funds and securities of unaffiliated custodians. Verification with unaffiliated custodians serves as a critical check on potential collusion when the adviser or its related person acts as custodian. The accountant preparing the internal control report is in the best position to perform this check because the accountant will have access to the information necessary to verify assets when testing controls over the custodian's reconciliation processes. For this reason, we are requiring this verification to be performed in connection with, and reported in, the internal control report.

As described in our guidance for accountants, the accountant's verification that client funds and securities are reconciled to an unaffiliated custodian (e.g., the Depository Trust Corporation) can be accomplished in one of two ways.[94] The accountant may either obtain direct confirmation, on a test basis, with unaffiliated custodians or perform other procedures designed to verify that the data used in reconciliations performed by the qualified custodian is obtained from unaffilated custodians and is unaltered.[95]

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92 Amended rule 206(4)-2(a)(6)(ii)(B).

93 See Proposing Release at Section II.B.2.

94 See Accounting Release.

95 In meeting this requirement, the accountant can also incorporate its own work performed pursuant to other regulatory requirements, such as requirements under the Exchange Act. Under rule 17a-13 under the Exchange Act, most brokers and dealers are required to conduct a securities count at least once each calendar quarter, which includes, among

We noted several specific control objectives in the Proposing Release that we suggested might be included in the scope of an internal control report prepared under the proposed rule.[96] Some commenters urged that we establish minimum control objectives that need to be addressed as part of the internal control report as a means of ensuring consistency in practice.[97] In response to these comments, we are identifying certain minimum control objectives within our revised guidance for accountants.

We are not requiring that a specific type of internal control report be provided under the rule as long as the objectives noted above are addressed. This flexibility should permit accountants of qualified custodians to leverage audit work they have performed to satisfy existing regulatory requirements to which these custodians are subject, or work currently performed as part of internal control reports prepared to meet client demand. In the Proposing Release, we indicated that a Type II SAS 70 report would be sufficient to satisfy the requirements of the internal control report.[98] As we noted in our guidance for accountants, a report issued in connection with an examination of internal control conducted in accordance with AT Section 601, Compliance Attestation ("AT 601") under

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other things, a physical examination and count of all securities held, verification (through confirmation or other form of outside documentation) of all securities deposited or otherwise subject to the broker-dealer's control or direction, and reconciliation of the results of such count and verification to the broker-dealer's records. Under rule 17a-5, the broker-dealer's independent accountant provides a supplemental report on internal control which addresses, among other things, the broker-dealer's compliance with rule 17a-13. See Rules 17a-13 and 17a-5 under the Exchange Act [17 CFR Parts 240.17a-13 and 17a-5].

96 See Proposing Release, at Section II.B.2.

97 See, e.g., AICPA Letter; Deloitte Letter.

98 See Proposing Release, at Section II.B.2.

the standards of the American Institute of Certified Public Accountants[99] would also be sufficient, provided that such examination meets the objectives set forth in our guidance.[100]

2. Related Persons

We are amending rule 206(4)-2, as proposed, to provide that an adviser has custody of any client securities or funds that are directly or indirectly held by a "related person" in connection with advisory services provided by the adviser to its clients.[101] A related person is defined by the rule as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser.[102] We received some support for this proposal.[103] Several commenters urged us to instead adopt the approach our staff has taken in no-action letters in which the staff expressed the view that custody of client assets by a related person would not be attributed to the adviser if the related person was operationally separate.[104] Those letters expressed our staff's views regarding the scope of the custody rule which, at that time, did not explicitly

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99 AT 601 provides guidance to accountants for engagements related to either a firm's compliance with the requirements of particular laws or rules, or the effectiveness of the firm's internal controls over compliance with those particular requirements.

100 We have made technical changes to the description of the internal control report in amended rule 206(4)-2(a)(6)(ii)(A) to reflect that our adopted rule permits use of internal control reports other than the Type II SAS 70.

101 Amended rule 206(4)-2(d)(2) (defining "custody").

102 Amended rule 206(4)-2(d)(7). For advisers that are part of multi-service financial organizations, for example, such related person custodians may include broker-dealers and banks.

103 See CFA Institute Letter; Cornell Letter; FPA Letter; NAAIM Letter.

104 See, e.g., IAA Letter; Mellon Letter; MMI Letter; NRS Letter; Pershing Letter. Several other commenters suggested similar approaches, including revising the definition of custody based on the factors the staff considered in these no-action letters (T. Rowe Letter), and not considering firms under common control to be deemed related persons under the rule (IAA Letter; Pickard Letter; Schnase Letter; SIFMA(PCLC) Letter). We are not adopting either of these approaches for the same reasons as explained above.

address the applicability of the rule to an entity related to the adviser as parent company, sister company or wholly-owned subsidiary that holds or has access to client assets.[105] We believe that the authority or influence an adviser may have over such related persons presents sufficient risks as a result of a related person's ability to obtain client assets, that we should treat the adviser itself as having custody over the client assets.[106] Therefore, we are adopting the amendment as proposed.[107]

We are, however, addressing commenters' concerns in a different way by providing a limited exception from the surprise examination requirements in circumstances when the adviser is deemed to have custody solely as a result of a related person having custody.[108] The exception is available to an adviser that is (i) deemed to have custody solely as a result of certain of its related persons holding client assets, and (ii) "operationally independent" of the custodian.[109]

As discussed above, a key premise of our approach to the custody rule is that client assets may be at greater risk when they are maintained by a related person of the investment adviser. As commenters suggested, however, firms under common ownership

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105 See, e.g., Crocker Investment Management Corp., SEC Staff Letter (Apr. 14, 1978) ("Crocker").

106 See Proposing Release, Section II.B.1. We note that under rule 206(4)-2, as amended, only client assets held by a related person "in connection with advisory services" provided by the adviser would be attributable to the adviser. See rule 206(4)-2(d)(2). Consequently, an adviser will not be deemed to have custody of client assets held with a qualified custodian that is a related person of the adviser if the adviser does not provide advice with respect to such assets.

107 Amended rule 206(4)-2. In light of our amended definition of custody, our staff is withdrawing several no-action letters to the extent such letters are inconsistent with this definition, including Crocker and Pictet et Cie, SEC Staff Letter (Jun. 22, 1980). Advisers, including those firms that have relied on these letters in the past, must comply with the amended rule.

108 Amended rule 206(4)-2(b)(6).

109 Id.

that are operationally independent of each other present substantially lower client custodial risks than those that are not because misuse of client assets would tend to require collusion among employees, not significantly different than would be necessary to engage in similar misconduct between unaffiliated organizations.[110]

Under the amended rule, a related person that holds, or has authority to obtain possession of, advisory client assets would be presumed not to be operationally independent of the adviser unless the adviser can meet the rule's conditions, which are similar to the factors that our staff has used to evaluate whether an adviser has custody of client funds and securities indirectly under the rule as a consequence of the custody of a related person,[111] and no other circumstances exist that can reasonably be expected to compromise the operational independence of the related person.[112] An adviser that is able to satisfy these conditions and overcome the presumption that it is not operationally independent of its related person would not have to obtain a surprise examination of client assets held by a related person, including a related person that is a qualified

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110 MMI Letter; Davis Polk Letter. This conclusion is implicit in our staff's no-action letter upon which the staff has relied to determine whether an adviser indirectly has custody of client assets when its related person does. See Crocker, supra note 105.

111 Amended rule 206(4)-2(d)(5) (defining "operationally independent"). The conditions set out in the rule are: (i) client assets in the custody of the related person are not subject to claims of the adviser's creditors; (ii) advisory personnel do not have custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person. We would not consider a related person that shared management persons with the adviser, including an owner that was actively involved in the management of the two firms, to be operationally independent.

112 For example, the management of the adviser and related person could be controlled by persons with close familial relationships such as spouses, siblings, or parents and adult children.

custodian. The adviser would, however, have to comply with the other provisions of the rule (unless an exception is available), including notifying the client where the assets are maintained, forming a reasonable belief after due inquiry that the qualified custodian sends the client account statements, and obtaining an internal control report from a related person that is a qualified custodian.[113] We believe that the conditions set out in the rule appropriately accomplish our objective of identifying advisers that are not operationally independent and thus present sufficient custodial risks that the adviser should be subject to a surprise examination.

We emphasize that an adviser that has custody due to reasons in addition to, or other than, a related person having custody <u>cannot</u> rebut the presumption contained in the rule. Thus, for example, an adviser that has custody because it serves as a trustee with respect to client assets held in an account at a broker-dealer that is a related person could not rely on the exception from the surprise examination on the grounds that the broker-dealer was operationally independent and that the factors discussed above were met.[114] Such an adviser would be subject to the surprise examination requirement <u>and</u> would have to receive an internal control report from the related person qualified custodian.[115]

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[113] We believe these safeguards remain important because even when an adviser has demonstrated that a related person is operationally independent, the risks to client assets raised by common control may be greater than if client assets were maintained by an independent custodian.

[114] We have also amended the rule so that the exception from the surprise examination requirement with respect to client assets of advisers that have custody as a result of their ability to deduct advisory fees from client assets applies to such advisers when their client assets are held by a custodian that is not a related person of the adviser as well as when the adviser can rely on amended rule 206(4)-2(b)(6). <u>See</u> amended rule 206(4)-2(b)(3). For the reasons described above, when the related person custodian is operationally independent, we do not believe the custodial risks raised warrant the costs of obtaining a surprise examination.

[115] Under the rule, an adviser whose client assets are maintained by a related person qualified custodian that is not operationally independent from the adviser, must

We are also amending rule 204-2 to require an adviser whose client assets are held by a related person but does not undergo a surprise examination to make and keep a memorandum describing the relationship with the related person in connection with advisory services the adviser provides to clients and including an explanation of the adviser's basis for determining that it has overcome the presumption that it is not operationally independent of the related person with respect to the related person's custody of client assets.[116]

3. PCAOB Registration and Inspection

Under the amendments, the surprise examination and internal control report required when the adviser or its related person serves as qualified custodian for client assets may be satisfied only when performed or prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.[117] We have greater confidence in the quality of the surprise examination and the internal control report when prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.

Many commenters supported this requirement, agreeing with us that PCAOB registration would provide an important quality check on the independent accountants

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obtain a surprise examination of those assets as if it held the assets itself and were required to obtain a surprise examination with respect to those assets. As a result, for example, a broker-dealer that is also a qualified custodian of its client's advisory assets could not avoid obtaining a surprise examination by creating an operationally integrated subsidiary to provide investment advice.

116 See amended rule 204-2(b)(5).

117 Amended rule 206(4)-2(a)(6). The independent public accountant must be registered with, and subject to regular inspection by, the PCAOB as of the commencement of the professional engagement period, and as of each calendar year-end.

performing these services.[118] Two of those commenters asserted that PCAOB registration would serve to discourage accounting fraud in the higher risk situation posed by an adviser or its related person maintaining client assets.[119] Commenters opposing the requirement expressed concern that the PCAOB's authority is limited to inspecting accountants with respect to audits of public issuers, which does not include the surprise examinations and internal control reports meeting the requirements of rule 206(4)-2.[120] One commenter urged us to exempt offshore advisers from this requirement, asserting that some foreign countries do not have enough accountants registered with the PCAOB to support a competitive marketplace for their services.[121]

We acknowledge that the PCAOB does not currently inspect auditor engagements required solely as a result of rule 206(4)-2. We nonetheless believe a requirement that excludes accountants that are not registered with and examined by the PCAOB will provide greater confidence in the quality of the independent public accountant and complement the enhanced controls under the rule that apply when client assets are not maintained by an independent qualified custodian and in audits of certain pooled investment vehicles.[122] While PCAOB inspection is focused on public company audit engagements, we believe that requiring that the accountant not only be registered with the

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118 Surprise exam and internal control report – E&Y Letter; NAAIM Letter; internal control report only – CPIC Letter; IAA Letter; Pickard Letter; NASAA Letter; surprise examination only – ABA Letter; Curian Letter; FPA Letter; Turner Letter.

119 CPIC Letter; FPA Letter.

120 CAS Letter; CAQ Letter; Chamber of Commerce Letter; FTAM Letter.

121 ABA Letter.

122 The PCAOB performs regular inspections with respect to any registered public accounting firm that, during any of the three prior calendar years, issued an audit report with respect to at least one issuer. Under the amended rule, an adviser's use of an independent public accountant that is registered with the PCAOB but not subject to regular inspection would not satisfy the rule's requirements. See PCAOB rule 4003.

PCAOB but subject to its inspection can provide indirect benefits regarding the quality of the accountant's other engagements.

We recognize that there may be fewer PCAOB-registered and inspected independent public accountants in certain foreign jurisdictions. Based on discussions with accounting firms, however, we do not expect advisers will have significant difficulty in finding a local auditor that is eligible under the rule. Many PCAOB-registered independent public accountants currently have practices in those jurisdictions in which most offshore advisers and funds are domiciled.[123] In addition, some accounting firms have international practices, which may ameliorate concerns regarding offshore availability. Finally, we will continue to monitor the situation as the rule is implemented and consider any issues that may arise.

D. Liquidation Audit

As proposed, the amended rule requires that advisers to pooled investment vehicles that distribute the pool's audited financial statements to investors under the rule's annual audit provision must, in addition to obtaining an annual audit, obtain a final audit of the pool's financial statements upon liquidation of the pool and distribute the financial statements to pool investors promptly after the completion of the audit.[124] This

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123 See http://www.pcaobus.org/Registration/Registered_Firms_by_Location.pdf. We also note that our staff has issued a letter indicating that it would not recommend enforcement action to the Commission under section 206(4) of the Advisers Act or rule 206(4)-2 under the Act against offshore advisers to offshore pooled investment vehicles if those advisers did not comply with certain substantive rules under the Advisers Act, including the custody rule. See ABA Subcommittee on Private Investment Entities, SEC Staff Letter (Aug. 10, 2006). The amendments we are adopting today do not affect the views of the staff expressed in that letter.

124 Amended rule 206(4)-2(b)(4). Each such set of audited financial statements must be prepared in accordance with generally accepted accounting principles.

amendment is designed to assure that the proceeds of the liquidation are appropriately accounted for so that pool investors can take timely steps to protect their rights.

One commenter thought that liquidation audits should not be required as the costs outweigh the benefits.[125] We disagree. We believe that a liquidation audit is an important control to protect assets at a time they may be particularly vulnerable to misappropriation.

E. Pooled Investment Vehicles

The custody rule's application to investment advisers to pooled investment vehicles will change in several aspects as a result of the amendments we are adopting today. Because a detailed discussion of each of these changes appears throughout multiple different sections of this Release, we are providing a centralized summary here.

Under amended rule 206(4)-2, advisers to pooled investment vehicles may be deemed to comply with the surprise verification requirements of the rule by obtaining an audit of the pool and delivering the audited financial statements to pool investors within 120 days of the pool's fiscal year-end.[126] The audit must be conducted by an accounting firm registered with, and subject to regular inspection by, the PCAOB.[127] If the pooled investment vehicle does not distribute audited financial statements to its investors, the adviser must obtain an annual surprise examination and must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement of the pooled investment vehicle to its investors in order to comply with the custody rule.[128]

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125 S&K Letter.

126 Amended rule 206(4)-2(b)(4). See supra note 45.

127 Amended rule 206(4)-2(b)(4)(ii).

128 Amended rule 206(4)-2(b)(4).

The rule requires the accounting firm performing the surprise examination to verify privately offered securities, along with other funds and securities, held by a pool that is not subject to a financial statement audit.[129] Regardless of whether an adviser to a pooled investment vehicle obtains a surprise examination or satisfies that requirement by obtaining an audit, if the pooled investment vehicle's assets are maintained with a qualified custodian that is either the adviser to the pool or a related person of the adviser, the adviser to the pool would have to obtain, or receive from the related person, an internal control report.[130] Finally, the rule requires advisers to pools complying with the rule by distributing audited financial statements to investors to also obtain an audit upon liquidation of the pool when the liquidation occurs prior to the fund's fiscal year-end.[131]

F. Delivery to Related Persons

The Commission is adopting a new provision in rule 206(4)-2 that would preclude advisers from using layers of pooled investment vehicles to avoid meaningful application of the protections of the Rule. Specifically, we are adding a new paragraph (c), which provides that sending an account statement (paragraph (a)(5)) or distributing audited financial statements (paragraph (b)(4)) will not meet the requirements of the rule if all of the investors in a pooled investment vehicle to which the statements are sent are themselves pooled investment vehicles that are related persons of the adviser.

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129 Section II.B.3. of this Release. Accounting firms that perform surprise examinations under the amended rule are required to report material deficiencies to our staff and also report on Form ADV-E the termination of an engagement as well as the results of the surprise examination.

130 See paragraphs (a)(6), and (b)(4) of amended rule 206(4)-2. This applies only where the use of a qualified custodian is required by the rule.

131 Amended rule 206(4)-2(b)(4)(iii).

Investment advisers to pooled investment vehicles may from time to time use special purpose vehicles (SPVs) to facilitate investments in certain securities by one or more pooled investment vehicles that the advisers manage. These SPVs are typically established or controlled by the investment adviser or its related persons who often serve as general partners of limited partnerships (or managing members of limited liability companies, or persons who hold comparable positions for another type of pooled investment vehicle). Therefore, a literal application of the rule could result in account statements and financial statements designed to permit investors to protect their interests being sent to the adviser itself, rather than to the parties the rule was designed to protect.[132]

To comply with the rule, as amended, the investment adviser could either treat the SPV as a separate client, in which case the adviser will have custody of the SPV's assets, or treat the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly. If the adviser treats the SPV as a separate client, rule 206(4)-2 requires the adviser to comply separately with the custody rule's audited financial statement distribution or account statement and surprise examination requirements (e.g., distribute audited financial statements of the SPV pursuant to the requirements of rule 206(4)-2). Accordingly, advisers should distribute the audited financial statements or account statements of the SPV to the beneficial owners of the pooled investment vehicles. If, however, the adviser treats the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly, such assets must be considered within the

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132 In certain circumstances, the use of SPVs could constitute a violation of section 208(d) of the Act, which prohibits an investment adviser, "indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under" the Act or any of our rules.

scope of the pooled investment vehicle's financial statement audit or surprise examination.

G. Compliance Policies and Procedures

Rule 206(4)-7 under the Advisers Act requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.[133] As we stated in 2003 when we adopted that rule, these policies and procedures must address, among other things, the safeguarding of client assets from conversion or inappropriate use by advisory personnel.[134] We believe that an adviser's maintenance of strong policies and procedures, in addition to the measures we are adopting today, is an essential component of a comprehensive approach to addressing the potential risks raised by an adviser's custody of client assets. We are therefore taking this opportunity to provide guidance regarding the types of policies and procedures relating to safekeeping of client assets that advisers should consider including in their compliance programs.

Compliance with rule 206(4)-7 requires an adviser with custody to adopt controls over access to client assets that are reasonably designed to prevent misappropriation or misuse of client assets, develop systems or procedures to assure prompt detection of any misuse, and take appropriate action if any misuse does occur.[135] Commenters on our Proposing Release suggested several policies and procedures that advisers should

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133 17 CFR 275.206(4)-7.

134 Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] ("Compliance Rule Release"), at Section II.A.1.

135 See id.

consider adopting in order to comply with rule 206(4)-7,[136] many of which we have incorporated into this guidance.

Advisers with custody of client assets should consider the value of instituting the following policies and procedures as part of their compliance programs:[137]

- conducting background and credit checks on employees of the investment adviser who will have access (or could acquire access) to client assets to determine whether it would be appropriate for those employees to have such access;
- requiring the authorization of more than one employee before the movement of assets within, and withdrawals or transfers from, a client's account, as well as before changes to account ownership information;
- limiting the number of employees who are permitted to interact with custodians with respect to client assets and rotating them on a periodic basis; and
- if the adviser also serves as a qualified custodian for client assets, segregating the duties of its advisory personnel from those of custodial personnel to make it difficult for any one person to misuse client assets without being detected.[138]

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136 See, e.g., Comment letter of Investment Adviser Association (March 6, 2009); CPIC Letter.

137 In addition to these policies and procedures, an adviser should consider: (i) policies and procedures to establish that it has a basis for its reasonable belief that qualified custodians send account statements to advisory clients; and (ii) if the adviser has overcome the presumption that it is not operationally independent of its related person under amended rule 206(4)-2(d)(5), policies and procedures reasonably designed to ensure that it continues to overcome the presumption set forth in that provision as long as it continues to rely on the provision. See supra Sections II.A and II.C.2. of this Release.

138 An adviser utilizing a segregation of duties approach should also consider having different personnel authorize custodial transfers from client accounts than those who

Advisers should consider including in their policies and procedures a requirement that any problems be brought to the immediate attention of the management of the adviser. Advisers also should consider developing policies regarding the ability of individual employees to acquire custody of client assets, because their custody may be attributable to the firm, which will thereby acquire responsibility for those assets under the rule. Many firms preclude employees from acquiring custody by prohibiting them from, for example, becoming trustees for client assets or obtaining powers of attorney for clients separate and apart from the advisory firm.[139] Advisers that permit employees to serve in capacities whereby the firm acquires custody of client assets should take steps to assure themselves that their employees' custodial practices conform to the firm's policies and procedures, and that the adviser's chief compliance officer ("CCO") has access to sufficient information to enforce those policies and procedures.

The adviser's custody of client assets presents elevated compliance risks for the adviser and its clients. Advisers and their CCOs therefore must accord these risks appropriate attention in the adviser's compliance program. Accordingly, the adviser should consider developing procedures by which the CCO periodically tests the effectiveness of the firm's controls over the safekeeping of client assets. For example, the CCO could periodically test the reconciliation of account statements prepared by advisers with account statements as reported by qualified custodians. In addition, the

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reconcile client account balances at the adviser with the custodian's records of client transactions and holdings.

139 When a supervised person of an adviser serves as the executor, conservator or trustee for an estate, conservatorship or personal trust solely because the supervised person has been appointed in these capacities as a result of family or personal relationship with the decedent, beneficiary or grantor (and not as a result of employment with the adviser), we would not view the adviser to have custody of the funds or securities of the estate, conservatorship, or trust. See 2003 Adopting Release at n.15.

CCO could compare, on a sample basis, client addresses obtained from the clients' qualified custodians to which the custodian sends client statements, with client addresses maintained by the adviser, to look for inconsistencies or patterns that suggest possible manipulation of address information as a means for concealing misappropriation from these accounts by advisory personnel.

Advisers that have custody as a result of their authority to deduct advisory fees directly from client accounts held at a qualified custodian should have policies and procedures in place that address the risk that the adviser or its personnel could deduct fees to which the adviser is not entitled under the terms of the advisory contract, which would violate the contract and which may constitute fraud under the Advisers Act. The adviser's policies and procedures should take into account how and when clients will be billed; be reasonably designed to ensure that the amount of assets under management on which the fee is billed is accurate and has been reconciled with the assets under management reflected on statements of the client's qualified custodian; and be reasonably designed to ensure that clients are billed accurately in accordance with the terms of their advisory contracts.[140] Examples of policies and procedures such an adviser should consider include:[141]

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140 Our staff has taken the view that, under some arrangements, clients may pay advisory fees deducted directly from assets held in their advisory accounts without causing the adviser to have custody of those assets and being subject to the custody rule. Under these arrangements, a client will instruct its qualified custodian as its agent to determine the amount of the advisory fee and to remit the amount of the fee to the adviser. Our staff therefore takes the view, under these circumstances, that the adviser has no access to the client's funds or securities. See Staff Responses to Questions About Amended Custody Rule, at Section III. Fee Deduction, Question III.3, available at http://www.sec.gov/divisions/investment/custody_faq.htm.

141 Some of these suggestions came from commenters. See, e.g., CPIC Letter.

- periodic testing on a sample basis of fee calculations for client accounts to determine their accuracy;
- testing of the overall reasonableness of the amount of fees deducted from all client accounts for a period of time based on the adviser's aggregate assets under management; and
- segregating duties between those personnel responsible for processing billing invoices or listings of fees due from clients that are provided to and used by custodians to deduct fees from clients' accounts and those personnel responsible for reviewing the invoices and listings for accuracy, as well as the employees responsible for reconciling those invoices and listings with deposits of advisory fees by the custodians into the adviser's proprietary bank account to confirm that accurate fee amounts were deducted.

Because different controls may be appropriate for different advisers in designing effective compliance programs, we are not suggesting a single set of policies and procedures. As we noted in 2003 when we adopted rule 206(4)-7, we recognize that advisers are too varied in their operations and size for such an approach to work.[142] Policies and procedures that are appropriate for a 500 employee firm that also operates as a broker-dealer will be unlikely to work (or be necessary) for a five person firm that provides asset allocation advice. Advisers with only a few employees may, for example, find segregation of duties impractical, but for advisers with a large number of employees such a control may be highly effective. Advisers to pooled investment vehicles should consider whether these practices, or others, should cover investor accounts in the pool,

[142] Compliance Rule Release, at Section II.A.1.

for example, to prevent an employee from misappropriating assets from the pool by processing false investor withdrawals. We have therefore provided the guidance set out above primarily in the form of examples; we expect advisers to tailor their custody policies and procedures to fit both the size and the particular risks that are raised by their business model.

H. Amendments to Form ADV

We are adopting several amendments to Part 1A and Schedule D of Form ADV. The amendments require registered advisers to report to us more detailed information about their custody practices in their registration form and to update the information. The information will enhance our ability to identify compliance risks associated with custody of client assets.[143] The amendments primarily affect only those advisers that have custody of client assets under rule 206(4)-2.

Item 7. We are adopting the amendments to Item 7 and Section 7.A. of Schedule D that we proposed to require each adviser to report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to the adviser's clients' funds or securities.[144] We did not receive comments on these proposed amendments. We also are amending Section 7.A. of Schedule D to require an adviser to report whether it has determined that it has overcome the presumption that it is not

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[143] These revisions respond in part to concerns raised by the Government Accountability Office in its August 2007 report on our examination program, which concluded that our examination staff should continue to assess and refine the risk algorithm to enhance the risk assessment process, which would include the identification and collection of additional data through Form ADV. See United States Government Accountability Office, Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent (August 2007), available at http://www.gao.gov/new.items/d071053.pdf.

operationally independent from a related person broker-dealer qualified custodian, and thus is not required to obtain a surprise examination for the clients' assets maintained at that custodian.

Item 9. We are adopting amendments to Item 9 to require each registered adviser to report to us: (i) whether the adviser or a related person has custody of client assets, and if so, both the total U.S. dollar amount of those assets as well as the number of clients for whose accounts the adviser or its related person has custody;[145] (ii) if the adviser, or a related person, acts as an adviser to a pooled investment vehicle, whether (a) the pool is audited, and (b) the qualified custodians send account statements to pool investors;[146] (iii) whether an independent public accountant conducts an annual surprise examination of client assets;[147] and (iv) whether an independent public accountant prepares an internal control report with respect to the adviser or its related person;[148] and (v) whether the adviser or a related person serves as qualified custodian for the adviser's clients.[149] In addition, we are amending Schedule D to require that advisers (i) identify and provide

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144 The item had required an adviser to identify on Schedule D of Form ADV each related person that is an investment adviser, but made reporting of the names of related person broker-dealers optional.

145 Items 9.A. and 9.B of Part 1A of Form ADV.

146 Item 9.C.(1) and (2) of Part 1A of Form ADV.

147 Item 9.C.(3) of Part 1A of Form ADV.

148 Item 9.C.(4) of Part 1A of Form ADV. Two commenters suggested that we eliminate the requirements in Item 9.C. that require an adviser to disclose the actions taken by the adviser's qualified custodian and accountant pursuant to the proposed custody rule (as well as corresponding portions of Schedule D), stating that advisers cannot guarantee third-party actions and that reporting compliance with aspects of the custody rule is an inappropriate use of Form ADV. See IAA Letter; MMI Letter. These items do not require an adviser to guarantee actions of third parties, but merely require the adviser to report on obligations it has (e.g., to form a reasonable belief) under the revised custody rule, which if not met would result in the adviser's violation of the rule.

149 Item 9.D. of Part 1A of Form ADV.

certain information about the accountants that perform audits or surprise examinations and that prepare internal control reports;[150] and (ii) to identify related persons, such as banks, that serve as qualified custodians with respect to their clients' funds or securities, but are not otherwise reported in Item 7. We also are amending Schedule D to require an adviser to report whether it has determined that it has overcome the presumption that it is not operationally independent from a related person qualified custodian, and thus is not required to obtain a surprise examination for the clients' assets maintained at that custodian.[151]

Several commenters generally supported these amendments to Form ADV, and many requested clarification or modification to parts of the form.[152] In response to several commenters' requests for clarification or modification of Item 9,[153] we have added an instruction to clarify that an adviser must separately report the amount of assets of which it has custody, excluding those assets maintained by a related person qualified

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150 In addition to providing the accountant's name and address, advisers must indicate whether the accountant is registered with and subject to regular inspection by the PCAOB. Advisers must also indicate whether the accountant's report contained an unqualified opinion. Section 9.C. of Schedule D to Part 1A of Form ADV. One commenter stated that we should not require advisers to report whether the accountants they, or their related persons, engage are registered with and subject to inspection by the PCAOB because this information is readily available on the PCAOB's website. See AICPA Letter. An adviser, or related person custodian, would have to collect this information in the course of retaining an accountant to perform the necessary engagements to comply with the revised custody rule, and we expect that accountants would make these representations to their clients. As a result, reporting this information should not be burdensome to advisers.

151 Section 9.D. of Schedule D to Part 1A of Form ADV.

152 Cornell Letter; IAA Letter; MMI Letter; NRS Letter; Turner Letter.

153 IAA Letter; NSCP Letter; ASG Letter; CAS Letter.

custodian, and the amount of assets of which a related person has custody, including when the related person serves as a qualified custodian.[154]

I. Amendments to Form ADV-E

We are adopting, as proposed, three amendments to the instructions to Form ADV-E. First, we have amended the form instructions to require that the form and the accompanying accountant's examination certificate be filed electronically with the Commission through the IARD.[155] Advisers will, however, continue to file form ADV on paper until the IARD system begins accepting electronic filings of Form ADV-E, which we expect to occur sometime in late 2010. Investment advisers will be notified at that time. The second and third amendments we are adopting conform Form ADV-E instructions to amended rule 206(4)-(2), which, as discussed above, requires that (i) the surprise examination certificate must be filed within 120 days of the time chosen by the accountant for the surprise examination,[156] and (ii) a termination statement be filed by an accountant within four business days of its resignation, dismissal, or removal.[157]

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154 We also are revising an existing instruction to Item 9.A. to specify that in addition to advisers that have custody only because they have authority to deduct fees that if they also have custody because a related person maintains client assets but the adviser has overcome the presumption of not being operationally independent they may continue to answer "no" to Item 9.A. Advisers must report information about these custody arrangements in Item 9.B.

It will be several months before FINRA, which operates the IARD for us, completes reprogramming the IARD to implement this change to Item 9. In the interim, advisers registered with the Commission should provide responses following the amended instruction.

155 Instruction 3(a) to Form ADV-E. Several comments supported electronic filing and the amendments to Form ADV-E generally. See Cornell Letter; IAA Letter; Turner Letter.

156 Instruction 3(i) to Form ADV-E.

157 Instruction 3(ii) to Form ADV-E. Commenters suggested that we revise the timing of the filing and that we do not make the filing available to the public. We have addressed these comments in Section II.B.2 of this Release. See supra notes 54 and 57 and accompanying text.

J. Required Records

We also are adopting amendments, as proposed, to rule 204-2 to require an adviser to maintain a copy of (i) the internal control report that such adviser is required to obtain or receive from its related person, pursuant to amended rule 206(4)-2(a)(6), and (ii) the memorandum describing the basis upon which the adviser determined that the presumption that any related person is not operationally independent, pursuant to amended rule 206(4)-2(d)(5), has been overcome, for five years from the end of the fiscal year in which, as applicable, the internal control report or memorandum is finalized. Requiring an adviser to retain a copy of these items will provide our examiners with important information about the safeguards in place at an adviser or related person that maintains client assets. Information from these records will also assist our staff in assessing custody-related risks at a particular adviser.

III. EFFECTIVE AND COMPLIANCE DATES

A. Effective Date

The effective date of the amendments to rules 206(4)-2, 204-2, and Forms ADV and ADV-E is [insert date 60 days after publication].

B. Compliance Dates and Related Rule Amendments

Advisers registered with us must comply with amended rules 206(4)-2, 204-2, and Forms ADV and ADV-E, as amended, on and after [insert date 60 days after publication], the effective date of these amendments, except as described below. Immediately upon the effective date advisers that have custody of client assets must promptly upon opening a custodial account on a client's behalf, and following any changes to the custodial account information, as specified in rule 206(4)-2(a)(2) send a notification to the client, including a legend urging the client to compare the account statements the client receives from the custodian with those the client receives from the adviser. Such legend should also be included in any account statements that advisers send to these clients after they are required to send the notification discussed above. In addition, immediately upon the effective date, each adviser that has custody of client assets must have a reasonable belief (except with respect to pooled investment vehicles the financial statements of which are audited and delivered to investors) that a qualified custodian sends account statements directly to clients at least quarterly, in accordance with rule 206(4)-2(a)(3). We believe 60 days is sufficient for advisers to comply with the amended rule regarding the three requirements described above because they are modifications to the existing rule requirements.

Compliance dates for other provisions of amended rules 206(4)-2, 204-2, and Forms ADV and ADV-E are described below.[158]

1. Surprise Examinations

An investment adviser required to obtain a surprise examination must enter into a written agreement with an independent public accountant that provides that the first examination will take place by December 31, 2010 or, for advisers that become subject to the rule after the effective date, within six months of becoming subject to the

158 Some commenters requested that we delay the compliance date by 12 - 24 months from the effective date of the rule. See Curian Letter; CAQ Letter; Dechert Letter; Deloitte Letter; E&Y Letter; KPMG Letter; PWC Letter. In determining the compliance dates for the amended rules and forms, we balanced the urgency of enhancing investor protection afforded under the Advisers Act, the need to provide sufficient time for advisers to comply with the requirements under the amended rules, and the extent of changes we made from the proposal on which the commenters' requests were based.

requirement.[159] If the adviser itself maintains client assets as qualified custodian, however, the agreement must provide for the first surprise examination to occur no later than six months after obtaining the internal control report.[160] We believe these compliance dates will provide sufficient time for an adviser to hire an independent public accountant for purposes of the surprise examination and for the accountant to perform the surprise examination.

2. Internal Control Reports

An investment adviser also required to obtain or receive an internal control report because it or a related person maintains client assets as a qualified custodian must obtain or receive an internal control report within six months of becoming subject to the requirement. As noted above, an adviser obtaining an internal control report because it (rather than a related person) also serves as a qualified custodian of its clients' assets (e.g., a broker-dealer) need not undergo a surprise examination until six months after obtaining the internal control report.

3. Audits of Pooled Investment Vehicles

An investment adviser to a pooled investment vehicle may rely on the annual audit provision if the adviser (or a related person) becomes contractually obligated to obtain an audit of the financial statements of the pooled investment vehicle for fiscal

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159 An adviser could first become subject to the surprise examination requirement by, for example, registering with the Commission or accepting custody of a client's assets.

160 An independent public accountant conducting a surprise examination on an adviser that also serves as the qualified custodian for its clients (i.e., self custody) would have to verify the existence of client assets with the adviser itself. Because of the added assurance of having an internal control report, we believe that investors would be better served if the first round of surprise examinations is conducted with the benefit of the internal control report. An adviser with multiple related persons that serve as qualified custodians must undergo a surprise examination within six months of receiving the last internal control report it is required to receive.

years beginning on or after January 1, 2010 by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.

4. Forms ADV and ADV-E

Investment advisers registered with us must provide responses to the revised Form ADV in their first annual amendment after January 1, 2011.[161] Until the IARD system is upgraded to accept Form ADV-E, accountants performing surprise examinations should continue paper filing of Form ADV-E. Investment advisers will be notified as soon as the IARD system can accept filings of Form ADV-E.[162]

IV. PAPERWORK REDUCTION ACT

Certain provisions of rule 206(4)-2, Form ADV, and Form ADV-E that we are amending today contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[163] In the Proposing Release, the Commission published notice soliciting comment on the collection of information requirements. The Commission submitted the collection of information requirements to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11 under control numbers 3235-0241, 3235-0049, and 3235-0361, respectively. The titles for the collections of information are "Rule 206(4)-2, Custody of Funds or Securities of Clients by Investment Advisers," "Form ADV," and "Form ADV-E, cover sheet for each certificate of accounting of client securities and

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161 Based on discussions with our contractor, we anticipate that IARD will reflect the changes to Form ADV we are adopting today and accept electronic filing of Form ADV-E in the fourth quarter of 2010. Form ADV-Es filed with us on paper before electronic filing will be available upon request through the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549.

162 We urge advisers in the meantime to confirm that their email contact information on Form ADV is correct and to update the information promptly if necessary.

funds in the custody of an investment adviser," under the Advisers Act.[164] An agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The collections of information under rule 206(4)-2 are necessary to ensure that clients' funds and securities in the custody of advisers are safeguarded, and information contained in the collections is used by staff of the Commission in its enforcement, regulatory, and examination programs. The respondents are investment advisers registered with us that have custody of client funds and securities ("client assets"). The collections of information under Form ADV are necessary for use by staff of the Commission in its examination and oversight program, and some advisory clients also may find them useful. The respondents are investment advisers seeking to register with the Commission or to update their registrations. The collections of information under Form ADV-E are necessary for use by staff of the Commission in its examination and oversight program, and some advisory clients also may find them useful. The respondents are investment advisers registered with us that have custody of client assets and are subject to an annual surprise examination requirement under rule 206(4)-2. All responses required by the rule are mandatory. With the exception of an accountant's

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163 44 U.S.C. 3501.

164 We also are adopting amendments to rule 204-2 that require approximately 337 advisers to maintain the internal control reports they obtain, or receive from related persons, and if these advisers have determined that the presumption that a related person is operationally independent has been overcome, a memorandum describing the basis upon which that determination was made. In addition, rule 204-2(a)(10) already requires an adviser to maintain all written agreements relating to its business as such, which would require an adviser to maintain the written agreement concerning the surprise examination required by the amended rule. The current approved collection of information burden for rule 204-2 is 1,945,109 hours and has an estimated cost of $13,551,390 under OMB control number 3235-0278. The two new retention requirements and the additional written

notification of any material discrepancies identified in a surprise examination pursuant to rule 206(4)-2(a)(4)(ii), responses provided to the Commission are not kept confidential.

A. Rule 206(4)-2

The Commission is adopting amendments to the custody rule under the Advisers Act. The amendments are designed to provide additional safeguards under the Advisers Act when a registered adviser has custody of client funds or securities by requiring such an adviser, among other things: (i) to undergo an annual surprise examination by an independent public accountant to verify client assets; (ii) to have a reasonable basis after due inquiry, for believing that the qualified custodian maintaining client funds and securities sends account statements directly to the advisory clients; and (iii) unless client assets are maintained by an independent custodian (i.e., a custodian that is not the adviser itself or a related person) to obtain or receive a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the PCAOB.

The amendments to rule 206(4)-2 that we are adopting today differ from our proposed amendments in three respects that affect our Paperwork Reduction Act analysis. First, we are providing an exception to the surprise examination requirement for advisers that have custody because they have authority to deduct advisory fees from client accounts and advisers that have custody solely because a related person holds the adviser's client assets and the related person is operationally independent of the adviser.[165] Second, advisers to pooled investment vehicles that are subject to an annual

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agreements that will be maintained as a result of more surprise examinations will result in a negligible increase to the currently approved burden for rule 204-2.

165 Amended rule 206(4)-2(b)(3) and amended rule 206(4)-2(b)(6).

audit and that distribute audited financial statements to investors in the pools are deemed to comply with the surprise examination requirement as long as the accountant performing the annual audit is registered with, and subject to regular inspection by, the PCAOB.[166] Third, if an adviser sends account statements to its clients, it must not only insert a legend in the required notice to clients upon opening accounts on their behalf, but must also insert the legend in subsequent account statements sent to those clients urging the client to compare the account statements from the custodian with those from the adviser.[167]

We requested comment on the Paperwork Reduction Act analysis contained in the Proposing Release. A number of commenters expressed concerns that the paperwork burdens associated with our proposed amendments to rule 206(4)-2 were understated.[168] In response to these comments as well as the differences in the amendments we are adopting from those we proposed, as described above, and the guidance for accountants published in a companion release,[169] we have adjusted our Paperwork Reduction Act estimates as discussed below.

Annual surprise examination. The current approved annual burden for rule 206(4)-2 is 415,303 hours, 21,803 of which relate to the requirement to obtain a surprise examination and the delivery of quarterly account statements by the adviser. We estimated in the Proposing Release that 9,575 advisers registered with the Commission

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166 Amended rule 206(4)-2(b)(4).

167 Amended rule 206(4)-2(a)(2).

168 See, e.g., ASG Letter; MMI Letter; Schwab Letter. These commenters did not provide empirical data that is relevant to our estimates of burden hours in this Paperwork Reduction Act analysis, but did provide cost estimates that we have considered in Section V of this Release.

169 See Accounting Release.

would be subject to the surprise examination.[170] As noted above, the amended rule we are adopting today excludes certain advisers with custody from the requirement to undergo an annual surprise examination and deems certain advisers to audited pooled investment vehicles to have complied with the requirement.[171] Advisers that have custody for other reasons, however, such as because they or their related person serves as the qualified custodian for client assets, or because they serve as the trustee of a client trust, must undergo an annual surprise examination.[172] As a result, we now estimate that 1,859 advisers will be subject to the surprise examination requirement under the amended rule 206(4)-2.[173]

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170 Based on Form ADVs filed as of February 2009. See the Proposing Release at n.77 for explanation of our estimate.

171 Amended rule 206(4)-2(b)(3) (exception from surprise examination for advisers that have custody because they have authority to deduct fees from client accounts) and amended rule 206(4)-2(b)(4)(deems advisers to audited pooled investment vehicles that distribute audited financial statements to pool investors to comply with the surprise examination requirement if the audit is conducted by a public accountant registered with, and subject to regular inspection by, the PCAOB). See supra Section II.B.1 of this Release.

172 Under amended rule 206(4)-2 an adviser has custody if its related person has custody of its client assets. Amended rule 206(4)-2(d)(2). A related person is defined as a person directly or indirectly controlling or controlled by the adviser, and any person under common control with the adviser. Amended rule 206(4)-2(d)(7).

173 Based on Form ADVs filed as of November 2, 2009 (unless indicated otherwise, all data we use in this release were as of November 2, 2009), there were 3,689 advisers that answered "yes" to Form ADV, Part 1A Items 9.A or 9.B (indicating that they or a related person has custody of client assets. This excludes advisers that have custody solely because they have authority to deduct fees from clients' accounts). We exclude from this number (i) 38 of these advisers that only have clients that are investment companies (Item 5.D(4)); (ii) 703 (or 90%, which is based on staff observation that the vast majority of pooled investment vehicles are subject to an annual audit) of the 781 of these advisers that only have clients that are pooled investment vehicles (Items 5.D(6) or 5.D(4)); (iii) 1,030 (or 80%) of the 1,288 advisers that have some clients that are pooled investment vehicles (10% of which is based on the number of advisers (from IARD data) that have both pooled investment vehicle clients and non-pooled investment vehicle clients that will not have to undergo a surprise examination because they do not have custody under the rule of the non-pooled investment vehicle client assets that would require a surprise examination and 10% of which is based on an estimate of the pooled investment vehicles that are subject to an annual audit). We further estimate that of the 396 advisers we estimate that are currently using related person qualified custodians, 59 (or 15%) will

For purposes of estimating the collection of information burden we have divided the estimated 1,859 advisers into 3 subgroups. First, we estimate that 337 advisers have custody because (i) they serve as qualified custodians for their clients and are also broker-dealers, banks or futures commission merchants,[174] or (ii) they have a related person that serves as qualified custodian for clients in connection with advisory services the adviser provides to the clients.[175] We estimate that these advisers will be subject to an annual surprise examination with respect to 100 percent of their clients (or 2,315 clients per adviser) based on the assumption that all of their clients maintain custodial accounts with the adviser or related person.[176] We estimate that each adviser will spend an average of 0.02 hours for each client to create a client contact list for the independent public

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choose to use independent qualified custodians and, as a result, will no longer retain custody of client assets under the rule that would require these advisers to undergo the surprise examination. See infra note 282 for explanation of this estimate. (3,689 – 38 – 703 – 1,030 – 59 = 1,859).

174 We estimate that 91 investment advisers that are also banks, registered broker-dealers or futures commission merchants would custody client assets as a qualified custodian under the rule.

175 Based on IARD data, we also estimate that 305 investment advisers have a related person bank, registered broker-dealer or futures commission merchant that is a qualified custodian for advisory client assets. 91 (advisers that are also banks or broker-dealers) + 305 (advisers using related persons as custodians) = 396. 396 – 59 (advisers that will stop using related persons as custodians) = 337 (see supra note 173 for explanation of 59 advisers removed).

176 In the Proposing Release, we estimated that each adviser had, on average, 1,092 clients. See Proposing Release at n.79. That estimate was based on the average number of clients of all advisers registered with us (excluding the two largest firms). We now base our estimate on IARD data of all the advisers that will be subject to the surprise examination under the amended rule (also excluding these two largest firms). This new estimate excludes from the calculation about 6,000 advisers that have custody solely because of deducting fees, which tend to have fewer clients. As a result the estimated average number of clients for the advisers that will be subject to the surprise examination under the amended rule is increased.

accountant. The estimated total annual aggregate burden with respect to the surprise examination requirement for this group of advisers is 15,603 hours.[177]

A second group of advisers, estimated at 1,315,[178] are those that have custody because they have broad authority to access client assets held at an independent qualified custodian, such as through a power of attorney or acting as a trustee for a client's trust. Based on our staff's experience, advisers that have access to client assets through a power of attorney, acting as trustee, or similar legal authority typically do not have access to all of their client accounts, but rather only to a small percentage of their client accounts pursuant to these special arrangements. We estimate that these advisers will be subject to an annual surprise examination with respect to 5 percent of their clients (or 116 clients per adviser)[179] who have these types of arrangements with the adviser. We estimate that each adviser will spend an average of 0.02 hours for each client to create a client contact list for the independent public accountant. The estimated total annual aggregate burden

177 337 advisers x 2,315 (average number of clients subject to the surprise examination requirement) x 0.02 hour = 15,603 hours. As addressed later, some of these advisers will not have to obtain a surprise examination as a result of the exception to the surprise examination requirement under amended rule 206(4)-2(b)(6) for an adviser that has custody because of its related person's custody of client assets and that can overcome the presumption that it is not operationally independent of the related person custodian. See infra note 283. We do not have data or another resource to provide an estimate of the number of advisers that use related person custodians that will be able to overcome the presumption. This estimated annual hour burden may, as a result, overestimate the collection of information requirement as advisers that have overcome the presumption will not have to create client contact lists.

178 This estimate is based on the total number of advisers subject to surprise examinations less those described above in the first group (custody as a result of serving as, or having related person serving as qualified custodians) and below in the third group (advisers to pooled investment vehicles) 1,859 - 337 - 207 = 1,315. See infra note 182 and accompanying text.

179 Based on the IARD data, we estimate that the average number of clients of advisers subject to the surprise examination requirement is 2,315. (2,315 x 5% = 116).

with respect to the surprise examination requirement for this group of advisers is 3,051 hours.[180]

A third group of advisers, estimated at 207,[181] provide advice to pooled investment vehicles that are not undergoing an annual audit, and therefore will be subject to the surprise examination with respect to 100 percent of their pooled investment vehicle clients (which we estimate to be 5 funds and 250 investors per adviser providing advisory services exclusively to pooled investment vehicles, and 2 funds and 100 investors per adviser not providing advisory services exclusively to pooled investment vehicles).[182] We estimate that the advisers to these pooled investment vehicles will spend 1 hour for the pool and 0.02 hours for each investor in the pool to create a contact list for the independent public accountant, for an estimated total annual burden with respect to the surprise examination requirement for these advisers of 1,296 hours.[183] These estimates bring the total annual aggregate burden with respect to the surprise examination

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180 1,315 x 116 x 0.02 = 3,051.

181 Based on IARD data, we estimate that there are 781 advisers that provide advisory services exclusively to pooled investment vehicles. See supra note 173. We further estimate, based on our staff's experience, that only ten percent of advisers to pooled investment vehicles will be subject to an annual surprise examination because the pooled investment vehicles they advise do not undergo an annual audit. We further estimate, based upon staff experience, that ten percent of the 1,288 advisers that provide services not exclusively to pooled investment vehicles will be subject to an annual surprise examination because the pooled investment vehicles they advise do not undergo an annual audit. (781 x 10%) + (1,288 x 10%) = 78 + 129 = 207.

182 The number of funds per adviser is estimated based on the information we collected from Item 5.C. of Form ADV filed by advisers that provide advisory services only to pooled investment vehicles. The estimate of 250 investors per adviser is a staff estimate used in the currently approved collection of information burden.

183 [(78 x 5) + (78 x 250 x 0.02)] + [(129 x 2) + (129 x 100 x 0.02)] = [390 + 390] + [258 + 258] = 1,296.

requirement for all three groups of advisers to 19,950 hours.[184] This estimate does not include the collection of information discussed below relating to the written agreement required by paragraph (a)(4) of the rule.

Written agreement with accountant. Consistent with the proposal, amended rule 206(4)-2 requires that an adviser subject to the surprise examination requirement must enter into a written agreement with the independent public accountant engaged to conduct the surprise examination and specify certain duties to be performed by the independent public accountant.[185] As stated in the Proposing Release, we believe that written agreements are commonplace and reflect industry practice when a person retains the services of a professional such as an accountant, and they are typically prepared by the independent public accountant in advance. We therefore estimate that each adviser will spend 0.25 hour to add the required provisions to the written agreement, with an aggregate of 465 hours for all advisers subject to surprise examinations.[186] Therefore the total annual burden in connection with the surprise examination is estimated at 20,415 hours under the amended rule.[187]

Audited pooled investment vehicles. The rule currently excepts, and the amended rule continues to except, advisers to pooled investment vehicles from having a qualified custodian send quarterly account statements to the investors in a pool if it is audited annually by an independent public accountant and the audited financial statements are distributed to the investors in the pool. The currently approved annual burden in

[184] 1,296 + 15,603 + 3,051 = 19,950. By contrast, our estimate in the Proposing Release for the surprise examination as proposed was 177,242 hours.

[185] Amended rule 206(4)-2(a)(4).

[186] 1,859 x 0.25 = 465.

[187] 19,950 + 465 = 20,415.

connection with the required distribution of audited financial statements is 393,500 hours.[188] As explained in the Proposing Release, we overestimated the burden for this delivery requirement in the past.[189] The collection of information burden imposed on an adviser relating to the mailing of audited financial statements to each investor in a pool that it manages should be minimal, as the financial statements could be included with account statements or other mailings. We estimate, consistent with the estimate in the proposing release, that the average burden for advisers to mail audited financial statements to investors in the pool is 1 minute per investor.[190] Under our revised estimate of the number of advisers to audited pooled investment vehicles,[191] we estimate that the aggregate annual hour burden in connection with the distribution of audited financial statements is 4,861 hours.[192]

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188 We estimated that 3,148 advisers to pooled investment vehicles were subject to this information collection under the current rule. We further estimated that each adviser had, on average, 250 investors in the funds it advises, and that each adviser spent 0.5 hours per investor annually for delivering audited financial statements to its 250 investors. 3,148 x 250 x 0.5 = 393,500.

189 We previously estimated that an adviser would spend 0.5 hours per investor sending investors audited financial statements. This estimate incorrectly included time for preparation of the audited financial statements, which after the audit should have been readily available to the adviser for distribution.

190 Proposing Release at n. 94.

191 Based on IARD data, 2,069 advisers with custody of client assets provided advice to pooled investment vehicles as of November 2, 2009. Of these 2,069 advisers, we estimate that 781 advisers will each on average provide advice to five pooled investment vehicles that have a total of 250 investors. 5 (pools) x 50 (investors) = 250. We estimate that of these 781 advisers, 703 (or 90%) will have their pooled investment vehicles audited and distribute the audited financial statements to the investors in the pool. We further estimate that of the remaining 1,288 advisers, on average, each provides advice to two pooled investment vehicles that have a total of 100 investors. 2 (pools) x 50 (investors) = 100. We estimate that of these 1,288 advisers, 1,159 (or 90%) will have their pooled investment vehicles audited and will distribute the audited financial statements to the investors in the pool.

192 [(703 x 250 x 1)/60] + [(1,159 x 100 x 1)/60] = 2,929 + 1,932 = 4,861.

The amended rule requires that an adviser to a pooled investment vehicle that is relying on the annual audit provision must have the pool audited and distribute the audited financial statements to the investors in the pool promptly after completion of the audit if the fund liquidates at a time other than its fiscal year-end. We estimate that 5 percent of pooled investment vehicles are liquidated annually at a time other than their fiscal year-end, which results in an additional burden of 243 hours per year.[193] As a result, the total annual hour burden in connection with the distribution of audited financial statements in connection with annual audit and liquidation audit under the amended rule is estimated to be 5,104 hours.[194]

Notice to clients. The amended rule also requires each adviser, if the adviser sends account statements in addition to those sent by the custodian, to add a legend in its notification to clients upon opening a custodial account on their behalf, and in any subsequent account statements it sends to those clients, urging them to compare the account statements from the qualified custodian to those from the adviser.[195] Although the legend requirement is new, it will be placed in a notification that is currently required to be sent to clients at specified times. We believe that the increase in this collection of information burden, if any, is negligible. We estimate that 80 percent of the 2,986 advisers would be subject to this collection of information,[196] and that each adviser will

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193 4,861 (total burden hours relating to distribution of audited financials) x 0.05 = 243.

194 4,861 + 243 = 5,104.

195 Amended rule 206(4)-2(a)(2).

196 We understand that advisers having custody solely because of deducting fees do not typically open custodial accounts on behalf of their clients. Excluding those advisers and 703 advisers to audited pooled investment vehicles to which the notice requirement does not apply, we estimate that 2,986 advisers may be subject to this information collection (advisers that answered "yes" to Item 9A. or B. of Part 1A. of Form ADV). See supra note 173 and accompanying text. Based on our staff's observation, we further estimate

adviser to obtain, or to receive from its related persons, an internal control report when the adviser or related person serves as qualified custodian for the adviser's clients' assets.

In the Proposing Release, we estimated that advisers subject to the surprise examination would on average pay an accounting fee of $8,100 annually.[202] Many commenters asserted that this estimate was too low.[203] In revising our estimates, we have considered the commenters' estimates,[204] engaged in further discussions with industry participants and accounting firms, including accounting firms that are registered with, and subject to regular inspection by, the PCAOB, and considered the cost implications for the surprise examination of certain aspects of our guidance for accountants that we are issuing today.[205] We now estimate that of the 1,859 advisers subject to the surprise examination requirement, 337 advisers will be subject to the surprise examination with respect to 100 percent of their clients and will each spend an average of $125,000 annually,[206] 262 medium sized advisers will be subject to the surprise examination

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201 See infra note 211 and accompanying text

202 See Proposing Release at n.102 and accompanying text.

203 See infra notes 276 to 278 and accompanying text.

204 We note that commenters based their cost estimates for surprise examinations on the current guidance for accountants, which requires verification of 100% of client assets. We believe that these estimates would have been significantly lower if they had reflected the modernized procedures for the surprise examination described in the guidance for accountants issued in a companion release. See Accounting Release.

205 Id.

206 As stated in infra note 282, we estimate, based on IARD data, that there will be 396 advisers that do not currently use an independent qualified custodian and will be subject to the surprise examination with respect to 100% of their clients. We expect 15% of these advisers will choose to use independent custodians instead of incurring these costs to comply with the rule. (396 x 85%) = 337.

We note that the costs of reporting to the Commission (i) regarding "material discrepancy" pursuant to amended rule 206(4)-2(a)(4)(ii) and (ii) upon termination of engagement pursuant to amended rule 206(4)-2(a)(4)(iii) are included in the estimated accounting fees.

requirement with respect to 5% of their clients and will each spend an average of $20,000 annually, and 1,260 small sized advisers will be subject to the surprise examination requirement with respect to 5% of their clients and will each spend an average of $10,000 annually, with an aggregate annual accounting fee of $59,965,000 for all advisers subject to the surprise examination.[207]

We understand that the cost to prepare an internal control report relating to custody will vary based on the size and services offered by the qualified custodian. We estimated in the Proposing Release that, on average, an internal control report would cost approximately $250,000 per year for each adviser subject to the requirement.[208] We

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207 (337 x $125,000) + (262 x $20,000) + (1,260 x $10,000) = $ 42,125,000 + $5,240,000 + $12,600,000 = $59,965,000. See infra notes 282 to 286 and accompanying text for explanation of the estimated amounts. We also note that we may have overestimated the costs for the surprise examination for advisers that have custody because a related person has custody of client assets in connection with advisory services. As we have indicated, as a result of the exception to the surprise examination requirement under amended rule 206(4)-2(b)(6) for an adviser that has custody because of its related person's custody of client assets and that can overcome the presumption that it is not operationally independent of the related person custodian, some of the 337 advisers may not have to obtain a surprise examination. Those advisers that overcome the presumption may, however, incur outside legal expenses to assist with that determination. See infra note 283.

208 One commenter, the Chamber of Commerce, generally stated that the Commission's estimate of $250,000 was too low, but did not provide alternative data. See the Chamber of Commerce Letter. Another commenter, Securities Industry and Financial Markets Association, however, concurred with our cost estimate of $250,000. See SIFMA(PCLC) Letter. A third commenter, Managed Funds Association, estimated that the internal control report of a hedge fund adviser would cost approximately $500,000 and over $1 million in some cases. See MFA Letter. We understand that advisers to pooled investment vehicles typically do not maintain client assets as qualified custodians and, as a result few advisers to pooled investment vehicles would have to obtain an internal control report. Rather, it is more likely that the internal control report would be for a related person broker-dealer, which costs we believe are accurately reflected in the comment letter sent by the Securities Industry and Financial Markets Association. See SIFMA(PCLC) Letter. After further consultation with several accounting firms that have experience in preparing Type II SAS 70 reports, including accounting firms that are registered with the PCAOB, we believe our estimate of $250,000 is reasonable. Moreover, we are not requiring that a specific type of internal control report be provided under the rule as long as the objectives noted above are addressed. This flexibility should permit accountants of qualified custodians to leverage audit work they have performed to

estimate that under amended rule 206(4)-2, 252 advisers will be subject to the requirement of obtaining or receiving an internal control report.[209] Therefore the total cost attributable to this requirement will be $63,000,000.[210] The total estimated accounting fee under the amended rule 206(4)-2 is therefore estimated at $122,965,000.[211]

One-time computer system programming costs. As stated above, the amended rule would require an adviser that has an obligation under the rule to provide a notice to clients upon opening a new account on behalf of the client or changes to such account and that sends account statements to its client to include in the account statement a legend urging the client to compare its account statement with those sent by the qualified custodian. We expect that the requirement would cause advisers that are subject to the notice requirement and that send account statements to clients to reprogram their computer system to include the legend in account statements to clients. We estimate that half of the advisers that are subject to the rule or 1,195 advisers will hire a computer programmer to modify their computer system to automatically add the legend to client

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satisfy existing regulatory requirements to which these custodians are subject, which may reduce the costs for advisers to comply with the internal control report requirement.

209 Of the 337 advisers (see supra note 206 for this estimate) that will be subject to both the surprise examination and internal control report requirement, we further estimate, based on consultation with several accounting firms, that 10% of these advisers already obtain an internal control report for purposes other than the custody rule. In addition, we believe that some related persons may serve as the qualified custodian for more than one affiliated adviser. We estimate that this will reduce the number of required internal control reports by an additional 15%. See infra notes 289 and 290 and accompanying text for explanation of this estimate. 337 – (337 x 10%) – (337 x 15%) = 337 – 34 – 51 = 252.

210 $250,000 x 252 = $63,000,000. See supra note 207 and infra notes 275 to 292 and accompanying text for explanation of our estimate of costs of the internal control report.

211 $59,965,000 (accounting fee for surprise examination) + $63,000,000 (accounting fee for internal control report) = $122,965,000.

account statements at an average cost of $1,000 each.[212] We believe the other half routinely use off-the-shelf software to provide client account statements and will bear little or no direct costs because we expect the software vendors will not pass the reprogramming costs on to their customers (i.e. the advisers) due to a very low per unit cost. Based on the above estimates, we believe that the total one-time computer system programming cost would be $1,195,000 for the advisers subject to this requirement.[213]

PCAOB registration. For an investment adviser to rely on the provision in amended rule 206(4)-2 that deems pooled investment vehicles to have satisfied the surprise examination requirement if audited financial statements are distributed to investors in the pool, the accountant that audits the pooled investment vehicle's financial statements must be registered with, and subject to regular inspection by, the PCAOB.[214] We acknowledge that not all pooled investment vehicle audits are performed by accountants meeting the PCAOB requirement as this is a new requirement. However, our staff has reviewed several third-party databases that contain the identity of accountants that perform these audits, and substantially all the pools that identified accountants were audited by PCAOB registered and inspected firms or their affiliates.[215] Moreover, a representative of venture capital firms stated that the "vast majority" of venture capital funds are audited and, as far as it could determine, all venture capital fund audits are conducted by PCAOB registered accounting firms that are subject to PCAOB

212 As stated above, we estimated that there will be 2,389 advisers subject to this requirement. See supra note 196 and accompanying text. 2,389/2 = 1,195.

213 1,195 x $1,000 = $1,195,000. See infra note 294 for explanation of the estimate.

214 Amended rule 206(4)-2(b)(4).

215 These databases do not distinguish between funds managed by registered advisers from those managed by exempt advisers (who would not be subject to the rule).

inspection.[216] As a result, we do not believe there will be a substantial dislocation of pooled investment vehicle auditors as a result of the amended rule. For those pools that will have to change accounting firms, we do not believe based on discussions with accountants that there will be additional costs to retain an accounting firm registered with, and subject to inspection by, the PCAOB, as accountants that perform these financial statement audits are likely to be with national accounting firms or accounting firms that specialize in auditing pooled investment vehicles and that charge equivalent fees to accountants registered with, and subject to inspection by, the PCAOB.[217]

B. Form ADV

In connection with our proposed amendments to Form ADV, we submitted cost and burden estimates of the collection of information requirements to the Office of Management and Budget ("OMB"). We estimated that these amendments would increase the annual information collection burden in connection with Form ADV from 22.25 hours to 22.50 hour for each adviser.[218] The total information collection burden resulting from the amendments would be 3,068 hours.[219] We solicited comment in the Proposing Release on our estimates, but did not receive comments. We do not believe that the

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216 NVCA Letter.

217 Two commenters expressed concerns about costs with respect to the requirement of PCAOB registration for accountants performing surprise examinations and preparing internal control reports for advisers that serve, or have related persons serve, as the qualified custodian for their client assets. See Consortium Letter; Chamber of Commerce Letter. These comments, however, were not directed to the costs of engaging PCAOB registered accountants for audits of pooled investment vehicles, and the commenters that did recommend the PCAOB requirement did not indicate there would be increased costs for such a requirement. See, e.g., CPIC Letter, MFA Letter.

218 See the Proposing Release at n.169 and accompanying text. We received no comments on the estimate and we are keeping the estimate unchanged.

219 See the Proposing Release at n.170 and accompanying text. We received no comments on the estimate and we are keeping the estimate unchanged.

amendments to Form ADV we are adopting today will result in a collection of information requirement different than what we estimated in the Proposing Release. Therefore, we are not revising our PRA burden and cost estimates submitted to the OMB with respect to Form ADV.

C. Form ADV-E

The currently approved collection of information for Form ADV-E is 9 hours. We estimate that this collection of information will increase to 112 hours based on the amendments.[220] This increase results primarily from an increase in the estimated number of advisers that will be subject to the requirement of completing Form ADV-E under the amended rule 206(4)-2 and the additional collections of information required by the amendments to the rule.[221]

For the currently approved annual hour burden for Form ADV-E, we estimated that 231 advisers would be subject to the annual surprise examination requirement, including the requirement to complete Form ADV-E, and that each of the advisers would spend approximately 0.05 hour to complete Form ADV-E. We now estimate that 1,859 advisers will be required to undergo an annual surprise examination and complete Form ADV-E, and that the total annual hour burden for Form ADV-E in connection with the surprise examination requirement will therefore increase to 93 hours.[222]

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220 We requested comment on our estimates of the collection of information burden relating to Form ADV-E and received no comment.

221 Form ADV-E is the cover sheet for the required filing with the Commission by the accountant performing the surprise examination pursuant to amended rule 206(4)-2(a)(4)(i) and (iii). The adviser completes Form ADV-E and provides it to the accountant, which results in an estimated hour burden for the advisers.

222 1,859 x 0.05 = 93.

In addition, amended rule 206(4)-2 requires an adviser subject to the surprise examination to enter into a written agreement with the independent public accountant that specifies the accountant's duties, including filing Form ADV-E upon the termination of its engagement. Based on an assumption that advisers change their independent public accountants every five years on average and an estimate that advisers spend approximately 0.05 hours to complete Form ADV-E, advisers will be required each year to complete Form ADV-E with respect to an accountant's termination with an annual burden of 19 hours.[223] The total annual hour burden for advisers to complete Form ADV-E in connection with the surprise examination and the termination statement will be 112 hours.[224]

V. COST-BENEFIT ANALYSIS

A. Background

The Commission is sensitive to the costs and benefits resulting from its rules. Rule 206(4)-2, the custody rule, seeks to protect clients' funds and securities in the custody of registered advisers from misuse or misappropriation by requiring advisers to maintain their clients' assets with a qualified custodian, such as a broker-dealer or a bank. The custody rule, as amended, requires <u>all</u> registered advisers that have custody of client assets to have a reasonable belief, formed after due inquiry, that a qualified custodian sends an account statement directly to each advisory client for which the qualified custodian maintains assets.[225] The amended rule also requires advisers that have custody

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223 1,859/5 = 372. 372 x 0.05 = 19.

224 93 + (372 x 0.05) = 93 + 19 = 112

225 Amended rule 206(4)-2(a)(3). We have retained the exception from the account statement delivery requirement for certain advisers to pooled investment vehicles. Amended rule 206(4)-2(b)(4).

of client assets to undergo an annual surprise examination by an independent public accountant with the exception of advisers that have custody solely because of their authority to deduct advisory fees from client accounts,[226] and advisers that have custody solely because a related person holds the adviser's client assets and the related person is operationally independent of the adviser.[227] In addition, advisers to pooled investment vehicles are deemed to comply with the surprise examination requirement if the pools are subject to an annual financial statement audit by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB, and if the audited financial statements are delivered to the pool's investors.[228]

We are also adopting amendments to the rule to impose additional requirements when advisory client assets are maintained by the adviser itself or by a related person rather than with an independent qualified custodian. The amended rule requires, in addition to the surprise examination discussed above,[229] that the adviser obtain, or receive from its related person, no less frequently than once each calendar year, a written report, which includes an opinion from an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets, such as a Type II SAS 70 report.[230] The amended rule also requires, in these circumstances, that the independent public accountant issuing the internal control report, as well as the

226 Amended rule 206(4)-2(b)(3). This exception would also be available to such an adviser when the adviser can rely on amended rule 206(4)-2(b)(6). See Section II.C.2. of this Release. The exception would not be available, however, to an adviser that has custody under the rule for other reasons.

227 Amended rule 206(4)-2(b)(6).

228 Amended rule 206(4)-2(b)(4).

229 Amended rule 206(4)-2(a)(6).

independent public accountant performing the surprise examination, be registered with, and subject to regular inspection by, the PCAOB.[231] The adviser must maintain the internal control report in its records and make it available to the Commission or staff upon request.[232]

Finally, we are adopting several amendments to Form ADV and Form ADV-E. The amendments to Form ADV require registered advisers to report to us more detailed information about their custody practices. The amendments to Form ADV-E require that the form and the accompanying accountant's examination certificate, or statement upon termination, be filed electronically with the Commission through the IARD and conform Form ADV-E instructions to amended rule 206(4)-(2).

In the Proposing Release, we requested comment and empirical data regarding the costs and benefits of the amendments. Most of the 1,300 commenters expressed their support for our goal of strengthening protections provided to advisory clients under the custody rule. One opined that the benefits of the proposed additional safeguards to investors whose assets are held in custodial accounts outweigh the costs to advisers.[233] Many, however, generally expressed concern about the costs, particularly to small advisers, of our proposal as it would have applied to advisers that have custody solely because of their authority to deduct advisory fees from client accounts.[234] As noted

230 Amended rule 206(4)-2(a)(6)(ii). As discussed in the costs section below, other types of reports could also satisfy the internal control report requirement.

231 Amended rule 206(4)-2(a)(6)(i) and (ii)(C).

232 Amended rule 204-2(a)(17)(iii).

233 CFA Institute Letter.

234 Of the 1,300 comment letters, approximately 1,100 were form letters or substantially similar letters submitted by smaller advisory firms that, in part, generally expressed

above, we have provided an exception from the surprise examination requirement for these advisers. Several commenters provided comments on the costs and benefits in the Proposing Release, which we address below.

B. Benefits

Improved protection for advisory clients. The rule and form amendments we are adopting today are designed to strengthen controls over the custody of client assets by registered investment advisers and to encourage the use of independent custodians. They will also improve our ability to oversee advisers' custody practices and, together with the guidance for independent public accountants that we are issuing, may prevent client assets from being lost, misused, misappropriated or subject to advisers' financial reverses. The benefits to investors are difficult to quantify, and commenters did not submit empirical data on potential benefits. We believe, however, that these benefits will be substantial, including, generally, increased confidence investors will have when obtaining advisory services from registered investment advisers. In addition, we believe the amendments to the rule could, to a limited extent, promote efficiency and capital formation as a result of such increased investor confidence. In particular, increased investor confidence could lead to more efficient allocation of investor assets, which could result in an increase in the assets under management of investment advisers and, depending on how those assets are invested, a potential increase in the availability of capital.

As described above, the amended custody rule requires investment advisers registered with us that have custody of client assets, subject to certain exceptions, to

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concerns regarding the costs of the proposal as it related to the surprise examination for advisers with custody solely due to authority to withdraw advisory fees.

obtain a surprise examination of client assets by an independent public accountant. As a result, advisers that have custody because, for example, they or their related person serves as qualified custodian for client assets, or because they serve as trustee of a client trust or have a power of attorney over client affairs, must undergo an annual surprise examination.[235] The surprise examination requirement should significantly contribute to deterring fraudulent conduct by investment advisers because advisers subject to the surprise examination will know their clients' assets are subject to verification at any time, and therefore may be less likely to engage in misconduct. If fraud does occur, the surprise examination requirement will increase the likelihood that fraudulent conduct will be detected earlier so that client losses will be minimized.[236] The additional review provided by an independent public accountant will also benefit advisory clients because it may help identify problems that clients may not be in the position to uncover through the review of account statements. We estimate that the rule will require 1,859 advisers[237] to obtain an annual surprise examination, and as a result provide the benefits identified above with respect to 956,237 clients.[238]

As amended, rule 206(4)-2 requires, in addition to the surprise examination discussed above, that when an adviser or its related person serves as a qualified custodian for advisory client assets, the adviser obtain, or receive from its related person, no less

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235 See Section II. B of this Release.

236 The independent public accountant conducting a surprise examination is required to verify client assets of which an adviser has custody, including those maintained with a qualified custodian and those that are not required to be maintained with a qualified custodian, such as certain privately offered securities and mutual fund shares.

237 See supra note 173 and accompanying text for explanation of this estimate.

238 [337 (advisers) x 2,315 (average number of clients for advisers subject to the surprise examination)] + (1,522 x 2,315 x 0.05(percentage of clients whose assets are subject to the surprise examination)) = 780,155 + 176,172 = 956,237.

frequently than once each calendar year, a written report, which includes an opinion from an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets ("internal control report"), such as a Type II SAS 70 report.[239] The amended rule also requires, in these higher risk situations, that the independent public accountant issuing the internal control report, as well as the independent public accountant performing the surprise examination, be registered with, and subject to regular inspection by, the PCAOB.[240]

The internal control report requirement will provide important benefits to advisory clients by imposing additional safeguards when client assets are maintained with the adviser or a related person. First, the internal control report will indicate whether the qualified custodian (the adviser or its related person) has established appropriate custodial controls by including an accountant's opinion regarding whether the custodian's internal controls are suitably designed and are operating effectively to meet control objectives related to custodial services, including the safeguarding of funds and securities.[241] Second, to satisfy the rule's requirements, the independent public accountant preparing the internal control report must verify that client assets are reconciled to a custodian other than the adviser or its related person, which will serve as a critical check when the custodian is not independent.[242] Third, an internal control report may also significantly strengthen the utility of the surprise examination when the adviser or a related person custodian maintains client assets because the independent public

239 Amended rule 206(4)-2(a)(6)(ii). As discussed in more detail below, other types of reports could also satisfy the internal control report requirement.

240 Amended rule 206(4)-2(a)(6)(i) and (ii)(C).

241 See Accounting Release.

242 Amended rule 206(4)-2(a)(6)(ii)(B).

accountant performing the surprise examination may obtain additional comfort that confirmations received from the qualified custodian in the course of the surprise examination are reliable. Clients of approximately 337 advisers will benefit from the protections provided by the internal control report requirement.[243]

As noted above, the amended rule provides a limited exception from the surprise examination requirement in certain circumstances when the adviser is deemed to have custody solely as a result of a related person having custody.[244] The exception is available to an adviser that is (i) deemed to have custody solely as a result of certain of its related persons holding client assets, and (ii) "operationally independent" of its related person.[245] Advisers that can overcome the presumption that they are not operationally independent of their related person will benefit from the cost savings of not having to obtain a surprise examination under these circumstances.[246] Clients may also benefit from this provision in two respects. First, it may encourage advisers with a choice of related person qualified custodians to use those that are operationally independent over those that are not, which may lower custodial risks to clients. Second, while clients will not have the benefit of the surprise examination under these circumstances, they will benefit from the protections of the internal control report that the adviser must receive from a related person that is a qualified custodian.

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243 See supra notes 174 and 175 and accompanying text for explanation of the estimated number. Because these advisers serve, or have a related person serve, as the qualified custodian for their client assets, they are subject to the internal control report requirement. Amended rule 206(4)-2(a)(6).

244 Rule 206(4)-2(b)(6).

245 Id.

246 We have estimated that each of these surprise examinations would cost an adviser $125,000. See infra notes 282 - 283 and accompanying text.

When the adviser or its related person serves as qualified custodian for client assets, the surprise examination and internal control report must be performed or prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.[247] We are also amending rule 206(4)-2 to require that in order to be deemed to comply with the surprise examination requirement, advisers to audited pooled investment vehicles must have the pool's annual audited financial statements prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB and distribute the audited financial statements to the investors in the pool.[248] Advisory clients and pool investors will benefit by having greater confidence in the quality of the surprise examination, the internal control report and pooled investment vehicle audits when performed or prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB. While PCAOB inspection is focused on public company audit engagements, we believe that requiring that the accountant not only be registered with the PCAOB but be subject to its inspection can provide indirect benefits regarding the quality of the accountant's other engagements.

The amendments also eliminate the alternative, currently provided in the rule, under which an adviser with custody can send its own account statements to clients if the adviser is subject to an annual surprise examination. Instead, all advisers with custody are required to have a reasonable belief, after due inquiry, that the qualified custodian sends account statements directly to clients. As a result, we expect that clients of approximately 190 advisory firms that currently send their own account statements to

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[247] Amended rule 206(4)-2(a)(6)(i) and (ii)(C).

clients will, under the amended rule, receive account statements directly from qualified custodians.[249] Where the qualified custodian is independent, this change provides advisory clients confidence that erroneous or unauthorized transactions will be reflected in the account statement. As a result, this change may deter advisers from engaging in fraudulent activities and allow clients to detect any unauthorized activity in their accounts promptly, thereby averting or reducing losses. Clients of these 190 advisers will benefit from this amendment and will start receiving account statements directly from qualified custodians.

The amended rule requires advisers to include a legend in the notice that they are currently required to send to their clients upon opening a custodial account on their clients' behalf if the adviser sends its own account statements to clients and in any subsequent account statements it sends to clients.[250] The legend will urge clients to compare the account statements they receive from the custodian with those they receive from the adviser. As discussed above, client review of periodic account statements from the qualified custodian is an important measure that can enable clients to discover improper account transactions or other fraudulent activity. Raising clients' awareness of this safeguard under the custody rule at account opening and with each subsequent account statement sent by the adviser may cause clients to uncover any unauthorized transactions by their advisers in their accounts more promptly, thereby averting or

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248 Amended rule 206(4)-2(b)(4).

249 Based on ADV-E filings, there were 190 advisers that underwent surprise examinations during 2008.

250 Amended rule 206(4)-2(a)(2).

reducing losses. We estimate that 250,367 clients would receive notices and subsequent account statements containing this additional information.[251]

Under the amended rule, each adviser that is required to undergo an annual surprise examination must enter into a written agreement with an independent public accountant to perform the surprise examination. The written agreement will require the independent public accountant to, among other things, (i) file Form ADV-E accompanied by a certificate within 120 days of the time chosen by the accountant for the surprise examination stating that it has examined the client assets and describing the nature and extent of the examination, (ii) report to the Commission any material discrepancies discovered in the examination within one business day, and (iii) upon the accountant's termination or dismissal, or removal from consideration for reappointment, file Form ADV-E within 4 business days accompanied by a statement explaining any problems relating to examination scope or procedure that contributed to the resignation, dismissal, removal, or other termination. These filings and reports will provide our staff additional information to assist in establishing advisers' risk profiles for purposes of prioritizing examinations. The rule will result in the electronic filing of Form ADV-E and the accountant statement on the IARD system.[252] Clients will benefit from electronic filing of the Form ADV-E because it will allow them to easily access important information

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251 We estimated that approximately 2,986 advisers open accounts on behalf of their clients. Based on our staff's observation, we further estimate that 80% of these advisers send account statements to their clients. (2,986 x 0.8 = 2,389). We estimate that each year these 2,389 advisers on average open accounts for about 5% of their 2,096 clients (average number of clients of the advisers with custody of client assets) who are either new clients or whose accounts have been transferred to new qualified custodians and that these advisers also send their own account statements to clients. (2,389 x (2,096 x 0.05) = 250,367).

about the surprise examinations performed on their advisers. We estimate that 4,303,585 advisory clients will benefit from the amendment.[253] Furthermore, the availability to the general public of Form ADV-E information on the Commission's web site may result in additional benefits, including deterring misconduct before it occurs and providing additional information for clients to consider when deciding which investment adviser to select.

We are adopting the amendments to Item 7 and Section 7.A. of Schedule D that we proposed to require each adviser to report all related persons who are broker-dealers and to identify which, if any, serve as qualified custodians with respect to the adviser's clients' funds or securities.[254] We are also amending Item 9 to require advisers that have custody (or whose related persons have custody) of client assets to provide additional information about their custodial practices under the custody rule. In addition, the revised Schedule D of Form ADV requires an adviser to provide additional details including information about the independent public accountants that perform annual audits, surprise examinations or that prepare internal control reports,[255] whether a report prepared by an independent public accountant contains an unqualified opinion,[256] and

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252 Until the IARD system is upgraded to accept Form ADV-E, accountants performing surprise examinations should continue paper filing of Form ADV-E. Investment advisers will be notified as soon as the IARD system can accept filings of Form ADV-E.

253 1,859 x 2,315 (average number of clients of the advisers subject to the surprise examination) = 4,303,585.

254 The item had required an adviser to identify on Schedule D of Form ADV each related person that is an investment adviser, but made reporting of the names of related person broker-dealers optional.

255 Section 9.C. of Schedule D of Form ADV.

256 Id.

about any related person that serves as a qualified custodian for the adviser's clients.[257] We also are amending Schedule D to require an adviser to report whether it has determined that it has overcome the presumption that it is not operationally independent from a related person qualified custodian, and thus is not required to obtain a surprise examination for the clients' assets maintained at that custodian. These disclosures will provide our staff more information to determine advisers' risk profiles and prepare for examinations. Moreover, this information will be filed electronically when IARD accepts these filings, and as a result the information will be available to the public through the Commission's web site. Clients will benefit directly from these amendments by obtaining more information about their advisers' custodial practices. They may also benefit indirectly because advisers will be incentivized to implement strong controls and practices to avoid receiving a qualified opinion from an independent public accountant.

Finally, under the amended rule, an adviser to pooled investment vehicles that is deemed to comply with the surprise examination requirement and that is excepted from the account statement delivery requirement by having the pooled investment vehicle audited and distributing the audited financial statements to the investors must, in addition to obtaining an annual audit, obtain a final audit of the fund's financial statements upon liquidation of the fund and distribute the financial statements to fund investors promptly after the completion of the audit.[258] This amendment provides fund investors the information necessary to protect their rights and to make sure that the proceeds of the liquidation are appropriately accounted for.

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[257] Section 9.D of Schedule D of Form ADV.

[258] Amended rule 206(4)-2(b)(4)(iii).

Improved clarity of the rule. We anticipate that investment advisers will find it easier to understand and comply with the rule as a result of the amendments, which may result in cost savings for advisers. The amendments will improve the clarity of the rule by adding several definitions, including amending the definition of "custody" to address related person custodian situations, and adding definitions of "control" and "related person."[259]

C. Costs

Surprise Examination. As noted above, the amended rule we are adopting today excludes certain advisers with custody from the requirement to undergo an annual surprise examination and deems certain others to comply with the requirement.[260] Advisers that have custody for other reasons, however, such as because they or their related person serves as the qualified custodian for client assets, or because they serve as the trustee of a client trust, must undergo an annual surprise examination.[261] As a result, we now estimate that 1,859 advisers will be subject to the surprise examination requirement under amended rule 206(4)-2.[262] Reducing that number by the 190 advisers

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259 Amended rule 206(4)-2(d).

260 Amended rule 206(4)-2(b)(3) (exception from surprise examination for advisers that have custody because they have authority to deduct fee from client accounts); amended rule 206(4)-2(b)(6) (exception from surprise examination for advisers that have custody solely because a related person holds the adviser's client assets and the related person is operationally independent of the adviser); and amended rule 206(4)-2(b)(4) (deemed compliance with the surprise examination requirement for advisers to audited pooled investment vehicles that distribute audited financial statements to pool investors if the audit was conducted by an independent public accountant registered with, and subject to regular inspection by, the PCAOB).

261 Under amended rule 206(4)-2 an adviser has custody if its related person has custody of its client assets. Amended rule 206(4)-2(d)(2). A related person is defined as a person directly or indirectly controlling or controlled by the adviser, and any person under common control with the adviser. Amended rule 206(4)-2(d)(7).

262 See supra note 173.

that already undergo an annual surprise examination under the current rule,[263] we estimate that the amendments will result in approximately 1,669 additional advisers being required to obtain a surprise examination.[264]

For purposes of the PRA analysis, we estimate that the total annual collection of information burden in connection with the surprise examination, before including the hours spent on conforming written agreements with accountants to the amended rule, will be 19,950 hours.[265] Based on this estimate, we anticipate that advisers will incur an aggregate cost of approximately $1,256,850 per year for these estimated hours.[266]

Written agreement. As proposed, amended rule 206(4)-2 requires that an adviser subject to the surprise examination requirement must enter into a written agreement with the independent public accountant engaged to conduct the surprise examination and specify certain duties to be performed by the independent public accountant.[267] As stated in the Proposing Release, we believe that written agreements are commonplace and reflect industry practice when a person retains the services of a professional such as an independent public accountant, and they are typically prepared by the accountant in advance. Because the amended rule applies to investment advisers (and not accountants) we believe that the burden to add the provisions to the written agreement will be borne by

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263 See supra note 249.

264 1,859 – 190 = 1,669.

265 See supra note 184 accompanying text for explanation of the estimate.

266 We expect that the function of providing lists of clients to the independent public accountant in assisting its examination, totaling 19,950 hours, would be performed by compliance clerks. Data from the Securities Industry and Financial Markets Association's Office Salaries in the Securities Industry 2008, 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, suggest that cost for this position is $63 per hour. Therefore the total costs would be $1,256,850.

267 Amended rule 206(4)-2(a)(4).

the adviser. We estimate that each adviser will spend 0.25 hour to add the required provisions to the written agreement, with an aggregate of 465 hours for all advisers subject to surprise examinations.[268] Requiring certain additional items to be included in the written agreement will not significantly increase costs for advisers.[269] Moreover, we do not believe that the new requirements placed on the independent public accountant by the written agreement (electronic filing of Form ADV-E and termination statement) will materially increase the accounting fees for the surprise examination discussed above.

For purposes of the PRA analysis, we estimate a total annual collection of information burden in connection with the surprise examination of 20,415 hours.[270] Based on this estimate, we anticipate that advisers will incur an aggregate cost of approximately $1,376,820 per year for the total hours their employees spend in complying with the surprise examination requirement.[271]

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268 1,859 x 0.25 = 465.

269 We estimate that it will take each adviser about 0.25 hour to add the required specifications. See supra note 186 and accompanying text. Converting the hour burden to costs, each adviser would spend $64.50. See infra note 271.

270 This estimated number includes the hours an adviser spends on providing client lists to the accountant performing the surprise examination and meeting the rule's requirements for the written agreement with the accountant regarding its engagement to perform the surprise examination. 15,603 hours (advisers subject to the surprise exam for 100% of clients to provide client lists) + 3,051 (advisers subject to the surprise exam for advisers with custody of a small portion of their clients to provide client lists) + 1,296 (advisers to pooled investment vehicles that are subject to the surprise examination to provide investor lists) + 465 (written agreement with accountants) = 20,415.

271 As we stated above, the total estimated burden hours related to the surprise examination requirement, before including the hours for written agreement with the accountant, are 19,950 hours with an estimated costs of $1,256,850. See supra note 184 for explanation of the estimated hours and supra note 266 for explanation of estimated cost. We expect that the function of adding certain duties of the accountant to the written agreement with the accountant, totaling 465 hours, would be performed by compliance managers. Data from the Securities Industry and Financial Markets Association's Management & Professional Earnings in the Securities Industry 2008, 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, suggest that the cost for this position is $258 per

In the Proposing Release, we estimated that there would have been 9,575 advisers subject to the surprise examination and they would each pay, on average, an annual accounting fee of $8,100 for the surprise examination.[272] The estimated total accounting fees for all surprise examinations would therefore have been $77,557,500.[273] As explained above, the amended rule excepts from the surprise examination requirement, advisers that have custody because of deducting advisory fees, and advisers that have custody solely because a related person holds the adviser's client assets and the related person is operationally independent of the adviser, and it deems advisers to audited pooled investment vehicles to comply with the requirement under certain circumstances,[274] reducing our estimated number of advisers subject to the surprise examination requirement from 9,575 to 1,859.[275]

Several commenters believed that our cost estimates for surprise examination accounting fees were too low.[276] Some of them provided their own estimates ranging from an amount close to our estimate (for smaller advisers),[277] to over one million dollars for the largest firms.[278] We believe that the costs of the surprise examination are lower than the costs suggested by commenters because commenters' estimates were based on

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hour. Therefore the total costs would be $1,376,820 ((19,950 x $63) + (465 x $258) = $1,376,820).

272 See Proposing Release at n.102 and accompanying text.

273 9,575 x $8,100 = $77,557,500.

274 See Section II.C.2. of this Release.

275 See supra notes 170 to 173 and accompanying text.

276 See, e.g., FPA Letter (estimated costs of $15,000 to $24,000), IAA Letter (estimated costs of $20,000 to $300,000).

277 CFP Board Letter (estimating cost of surprise examination from $5,000 to $10,000).

278 SIFMA(PCLC) Letter (member survey indicated average cost estimate of $200,000 with one response of over $1,000,000).

two critical assumptions that no longer are valid. First, these estimates were generally based on an understanding that the examination would involve verifying 100% of client assets, as is currently required under our existing guidance for accountants.[279] The revised guidance for accountants we are issuing, however, among other things, permits accountants to use sampling in the course of the surprise examination.[280] Second, many of these estimates are based on an assumption that an adviser would have custody of all of its clients' accounts based on our proposal to require the surprise examination if an adviser had custody because of the authority to deduct advisory fees directly from client accounts. The rule now provides an exception from the surprise examination when fee deduction is the reason the adviser has custody. As a result, many advisers that have custody under the amended rule will have custody with respect to a limited number of client accounts, and the scope of work for the accountant performing the surprise examination will be significantly reduced.

While, for reasons discussed above, we believe commenters' estimates of the cost of surprise examination are too high, they have caused us to reexamine our cost estimates and to determine that it would be more appropriate to categorize advisers into subcategories to estimate surprise exam costs. Instead of a single average cost, we have divided the 1,859 advisers that are subject to the surprise examination requirement into three distinct groups.[281] We now estimate that 337 advisers either serve as qualified

279 See ASR No. 103.

280 See Accounting Release.

281 The revised estimated costs are based on the experience of our staff and discussions with public accounting firms regarding the surprise examination requirement, modern accounting practices, and commenters' estimates.

custodian for their clients or have a related person that serves as qualified custodian.[282] These advisers would likely be subject to the surprise examination with respect to 100 percent of their clients, and as these advisers typically are large advisers with many clients, we estimate they will each spend an average of $125,000 annually.[283] We estimate that the rest of the advisers will be subject to surprise examination with respect

282 Based on IARD data, we estimated 396 advisers either serve as qualified custodian for their clients or have a related person that serves as qualified custodian. These advisers would likely be subject to the surprise examination with respect to 100 percent of their clients. We expect 15% of these advisers will use independent custodians instead of incurring these costs. This estimate is based on comments that we received about the high costs of the proposed requirements with respect to advisers using a related person as the qualified custodian. We believe that these advisers will do their own analysis of the benefits of continuing using their related persons as qualified custodians. Some of the advisers that maintain client assets with their related person custodians on an incidental basis may decide to use independent qualified custodians instead to avoid the costs of complying with the requirements. (396 x 85%) = 337.

283 Several of these large advisers are advisers with thousands of client accounts, while others have significantly fewer client accounts. The largest advisers will likely incur expenses higher than $125,000. Whereas those with significantly fewer client accounts will likely incur expenses less than $125,000. Moreover, as a result of the exception to the surprise examination requirement under amended rule 206(4)-2(b)(6) for an adviser that has custody because of its related person's custody of client assets and that can overcome the presumption that it is not operationally independent of the related person custodian, some of these 337 advisers would not have to obtain the surprise examination. We do not have data or another resource to provide an estimate of the number of advisers that use related person custodians that will be able to overcome the presumption. As a result, we are unable to estimate with specificity the reduced costs due to this exception. We do estimate that of the 337 advisers subject to the surprise examination, that 259 (after the 15% reduction noted above) use related person qualified custodians. See supra note 175. If 75% of the 259 of these advisers could overcome the presumption, the cost estimates for the surprise examination would be overstated by $24,281,250 ((259 x .75) x $125,000), if one half of them could overcome the presumption the costs would be overstated by $16,187,500 ((259 x .5) x $125,000), or if one quarter of them could overcome the presumption the costs would be overstated by $8,093,750 ((259 x .25) x $125,000). Those advisers that overcome the presumption may, however, incur outside legal expenses to assist with the determination. We estimate that on average, such legal assistance would cost an adviser between $4,000 (for 10 hours) and $16,000 (for 40 hours), significantly less than the estimated costs for the surprise examination. The hourly cost estimate of $400 on average is based on our consultation with advisers and law advisers who regularly assist them in legal and compliance matters.

to 5 percent of their client accounts.[284] We have divided these 1,522 advisers into two groups based on their number of clients: 262 medium-sized advisers and 1,260 small-sized advisers.[285] We estimate that medium-sized advisers will on average have accounting fees of $20,000 annually and small-sized advisers will on average have accounting fees of $10,000 annually for the surprise examination. Therefore the aggregate account fee relating to the surprise examination is estimated at $59,965,000.[286]

<u>Internal Control Report.</u> Under amended rule 206(4)-2, if an adviser or a related person serves as a qualified custodian for client assets in connection with advisory services the adviser provides to clients, the adviser must obtain, or receive from the related person, no less frequently than once each calendar year, a written report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the PCAOB. We estimate that approximately 337 investment advisers must obtain, or receive from a related person, an internal control report relating to custodial services.[287] One securities industry commenter noted that custodians often already provide Type II SAS 70 reports to clients who demand a rigorous evaluation of internal control as a condition of

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284 Advisers are required to undergo an annual surprise examination with respect to only those client accounts to which they have access that causes them to have custody, including through a power of attorney, acting as trustee, or similar legal authority. Based on the experience of our staff, we estimate that on average, only 5 percent of client accounts of these advisers will be subject to the surprise examination.

285 Based on responses to Item 5.C of Form ADV, we estimate that the average number of clients for these 1,522 advisers is 806. We determined, for purposes of this analysis, that an adviser with clients more than this average number is a medium size adviser and an adviser with clients less than this average number is a small adviser. 337 + 262 + 1,260 = 1,859.

286. (337 x $125,000) + (262 x $20,000) + (1,260 x $10,000) = $42,125000 + $5,240,000 + $12,600,000 = $59,965,000.

287 <u>See</u> <u>supra</u> notes 276-278 for explanation of this estimate.

obtaining their business.[288] We estimate that 10% of the advisers that must obtain or receive an internal control report will themselves or their related person qualified custodian will already obtain an internal control report for purposes other than the custody rule.[289] In addition, a single internal control report will satisfy the rule's requirement for several related advisers if their clients use the same related person as qualified custodian. We estimate that this will reduce the number of required internal control reports by an additional 15%.[290] As a result, we estimate that independent public accountants will prepare 252 internal control reports as a result of the rule amendments. Based on discussions with accounting professionals, we understand that the cost to prepare an internal control report relating to custody will vary based on the size and services offered by the qualified custodian, but that on average an internal control report will cost approximately $250,000 per year,[291] for total costs attributable to this section of the proposed rule to be $63,000,000.[292] These advisers also will need to maintain the report as a required record. We anticipate that the cost of maintaining these records will be minimal.

Although the amended rule does not require use of an independent custodian, we encourage the use of custodians independent of the adviser to maintain client assets as a best practice whenever feasible. As a result of the amendments and our encouragement, there may be effects on competition if additional advisers (and clients) begin using

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288 SIFMA(AMG) Letter.

289 Our estimate of 10% is based on our consultation with accounting firms that have experience in preparing internal control reports. 337 x 10% = 34.

290 Our estimate of 15% is based on the IARD data. 337 x 15% = 51.

291 <u>See</u> <u>supra</u> note 208 and accompanying text for explanation of this estimate.

292 $250,000 x (337 – 34 – 51) = $250,000 x 252 = $63,000,000

independent custodians, which is a common practice of many advisers today, particularly among those that are not themselves, or affiliated with, large financial service firms.

The total cost estimate above may overestimate actual costs incurred for internal control reports because of the factors discussed below. Accountants preparing an internal control report may incorporate relevant audit work performed for other purposes, including audit work performed to meet existing regulatory requirements, which should increase efficiencies in the audit process. These efficiencies are not represented in the estimated costs as the estimates are based on a custodian entering a new engagement for an internal control report. And any report that meets the objectives of the internal control report would be acceptable under the rule. In addition to the Type II SAS 70 report, other reports a qualified custodian already obtains could satisfy the rule's requirements. For instance, a report issued in connection with an attestation conducted in accordance with AT 601 under the standard of the AICPA would be sufficient, provided that such examination meets the objectives set forth in our guidance for accountants.

<u>One-time computer system programming costs.</u> As stated above, the amended rule would require an adviser that has obligation under the rule to provide a notice to clients upon opening a new account on behalf of the client or changes to such account and that sends account statements to its client to include in the account statement a legend urging the clients to compare its account statement with those sent by the qualified custodian. We expect that the requirement would cause advisers that are subject to the notice requirement and that send account statement to clients to reprogram their computer system to include the legend in account statements to clients. We estimate that half of the advisers that are subject to the rule or 1,195 advisers will hire a computer programmer to

modify their computer system to automatically add the legend to client account statements at an average cost of $1,000 each.[293] We believe the other half routinely use off-the-shelf software to provide client account statements and will bear little or no direct costs because we expect the software vendors will not pass the reprogramming costs on to their customers (i.e. the advisers) due to a very low per unit cost. Based on the above estimates, we believe that the total one-time computer system programming cost would be $1,195,000 for the advisers subject to this requirement.[294]

PCAOB registration. For an investment adviser to rely on the provision in amended rule 206(4)-2 that deems pooled investment vehicles to have satisfied the surprise examination requirement if audited financial statements are distributed to investors in the pool, the accountant that audits the pooled investment vehicle's financial statements must be registered with, and subject to regular inspection by, the PCAOB.[295] We acknowledge that not all pooled investment vehicle audits are performed by accountants meeting the PCAOB requirement as this is a new requirement. However, our staff has reviewed several third-party databases that contain the identity of accountants that perform these audits, and substantially all the pools that identified accountants were

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293 As stated above, we estimated that there will be 2,389 advisers subject to this requirement. See supra note 196 and accompanying text. 2,389/2 = 1,195.

294 1,195 x $1,000 = $1,195,000. Data from the Securities Industry and Financial Markets Association's Management & Professional Earnings in the Securities Industry 2008, 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, suggest that the cost for this position is $193 per hour. We further estimate that such reprogramming will take about 5 hours for each adviser. $193 x 5 hours = $965. Based on the above, we estimate that each adviser will spend approximately $1,000 as reprogramming costs.

295 Amended rule 206(4)-2(b)(4).

audited by PCAOB registered and inspected firms or their affiliates.[296] Moreover, a representative of venture capital firms stated that the "vast majority" of venture capital funds are audited and, as far as it could determine, all venture capital fund audits are conducted by PCAOB registered accounting firms that are subject to PCAOB inspection.[297] As a result, we do not believe there will be a substantial dislocation of pooled investment vehicle auditors as a result of the amended rule. For those pools that will have to change accounting firms, we do not believe based on discussions with accountants that there will be additional costs to retain an accounting firm registered with, and subject to inspection by, the PCAOB, as accountants that perform these financial statement audits are likely to be with national accounting firms or accounting firms that specialize in auditing pooled investment vehicles and that charge equivalent fees to accountants registered with, and subject to inspection by, the PCAOB.[298]

Liquidation Audit. The amended rule specifically requires an adviser to a pooled investment vehicle that is relying on the annual audit provision to obtain a final audit if the pool is liquidated at a time other than the end of a fiscal year.[299] This requirement will assure that the proceeds of the liquidation are appropriately accounted for. We believe this requirement will not materially increase the costs for advisers to pooled

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296 These databases do not distinguish between funds managed by registered advisers from those managed by exempt advisers (who would not be subject to the rule).

297 NVCA Letter.

298 Two commenters expressed concerns about costs with respect to the requirement of PCAOB registration for accountants performing surprise examinations and preparing internal control reports for advisers that serve, or have related person serve, as the qualified custodian for their client assets. See Consortium Letter; Chamber of Commerce Letter. These comments, however, were not directed to the costs of engaging PCAOB registered accountants for audits of pooled investment vehicles, and the commenters that did recommend the PCAOB requirement did not indicate there would be increased costs for such a requirement. See, e.g., CPIC Letter, MFA Letter.

investment vehicles because we believe most of these pooled investment vehicles are subject to contractual obligations with their investors to obtain a liquidation audit.[300] For purposes of PRA analysis, we estimate that advisers will spend 243 hours complying with the requirement[301] and thus will incur an aggregate cost of $15,309 for all advisers subject to the requirement.[302]

Qualified Custodian Account Statements. With the exception of advisers to certain pooled investment vehicles that distribute audited financial statements, the amended rule requires all registered advisers that have custody of client assets to have a reasonable belief, after due inquiry, that the qualified custodian sends account statements directly to their clients at least quarterly. We believe few advisers will have to change their practices to meet the requirement that all clients receive account statements directly from qualified custodians. Most advisers subject to the rule have qualified custodians that deliver account statements directly to clients and already conduct an inquiry of whether the qualified custodian sends account statements to clients.[303] For those advisers that previously had sent account statements directly to clients instead of having the

299 Amended rule 206(4)-2(b)(4)(iii).

300 As discussed above, amended rule 206(4)-2(c) provides that an adviser's sending an account statement (paragraph (a)(5)) or distributing audited financial statements (paragraph (b)(4)) will not meet the requirements of the rule if all of the investors in a pooled investment vehicle to which the statements are sent are themselves pooled investment vehicles that are related persons of the adviser. We do not believe this requirement will impose new costs on advisers under the rule because the application of the rule as required by this new provision was incorporated into our prior cost estimates.

301 See supra note 193 and accompanying text.

302 243 x $63 (hourly wage) = $15,309. See supra note 266 for explanation of advisory employee wage estimate.

303 Filing data indicates that 190 advisers (other than those that have custody but only have pooled investment vehicle clients that are subject to an annual audit) did not have the qualified custodian send account statements directly to their clients.

qualified custodian send account statements to clients, the costs should not be significant because qualified custodians send account statements to clients in their normal course of business. The requirement that advisers form their reasonable belief after due inquiry similarly should not have significant costs, as we understand that today most advisers receive duplicate copies of client account statements from custodians.

Based on the above analysis, we conclude that the aggregate annual accounting fee to comply with the surprise examination requirement and the internal control report requirement under amended rule 206(4)-2 is estimated at $122,965,000. In addition, we estimate that the total hours spent by advisory employees to comply with the amendments[304] will be 29,003 at a total cost of $1,917,864[305] The total cost estimated for complying with amendments to 206(4)-2 is estimated at $126,077,864.[306]

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304 The total hours include time spent to produce client contact lists for the accountant performing the surprise examination, add required language in a written agreement with the accountant engaged to perform the surprise examination, prepare a required legend in notices and subsequent statements to clients urging them to compare information contained in the account statements sent by the adviser with those sent by the qualified custodian, and distribute audited financial statements, including those related to liquidation audit, to fund investors. See Section IV of this Release for explanation of the estimates.

305 See supra notes 270 and 271 and accompanying text for explanation of these estimates. [(19,950 (employee hours for surprise examination) + 243 (employee hour for distributing audited financials related to liquidation audit) + 8,345 (employee hours for adding a legend in the notice to clients)) x $63] + (465 (employee hours for adding language in written agreements) x $258) = $1,797,894 + $119,970 = $1,917,864.

We estimated that advisory employees will spend a total of 41,724 hours to comply the notice requirement. The estimated 8,345 hours noted above for adding the legend to the required notice represents 20% of the total hour burden relating to the notice, which is 41,724 hours. (41,724 x 0.2) = 8,345. See supra note 197 for explanation of the estimate.

306 ($122,965,000 (aggregate accounting fees) + $1,917,864 (costs of hours advisory employees spent) + $1,195,000 (cost of one-time computer system programming) = $126,077,864).

Form ADV. We are adopting substantially as proposed several amendments to Part 1A of Form ADV that are designed to provide us with additional details regarding the custody practices of advisers registered with the Commission, and to provide additional data to assist in our risk-based examination program. For purposes of the PRA analysis, we estimated that these amendments will increase the annual information collection burden in connection with Form ADV from 22.25 hours to 22.50 hour for each adviser.[307] The total information collection burden resulting from the amendments would be 3,068 hours.[308] Based on this estimate, we anticipate that advisers will incur an aggregate cost of approximately $193,284 per year for the total hours their employees spend in connection with the amendments to Form ADV.[309]

Form ADV-E. For purposes of the PRA analysis, we estimate that the collection of information in connection with Form ADV-E will increase from the currently approved 9 hours to 112 hours based on the requirements of the amended rule. This increase results from an increase in the estimated number of advisers that will be subject to the requirement of completing Form ADV-E under the amendments to rule 206(4)-2 and the additional collections of information required by the amendments relating to completing Form ADV-E when an independent public accountant performing the surprise

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307 See supra note 218 and accompanying text.

308 See supra note 219 and accompanying text. We received no comments on the estimate and we are keeping the estimate unchanged.

309 We expect that the function of completing Form ADV would be performed by compliance clerks at a cost of $63 per hour. The total cost would be $193,284 (3,068 x $63 = $193,284). See supra note 266 for explanation of the hourly compliance clerk cost estimate.

examination terminates its engagement. This represents an increase of 103 hours[310] with an estimated aggregated annual cost of approximately $7,056.[311]

We recognize that there also might be certain costs to investment advisers, advisory clients and others that are not easily quantifiable. For instance, some advisers may choose to only use independent qualified custodians, and as a result, they may lose advisory clients if those clients insist on maintaining their assets with a particular custodian that happens to be a related person of the adviser. Advisory clients that are unwilling to change custodians also may lose the ability to hire an adviser that is related to the custodian if the adviser will only accept clients that use independent custodians. Advisers that chose to only use independent qualified custodians might also lose efficiencies that resulted from self-custody or related person custody arrangements, which could result in increased costs to advisory clients. Additionally, to the extent that advisers discontinue existing relationships with custodians, accountants or other service providers as a result of, or as required by, the amended rule, these service providers may lose revenues and incur other costs.

Based on the above analysis, we estimate that the aggregate costs for complying with the amendments to rule 206(4)-2, rule 204-2, Form ADV, and Form ADV-E will be $126,278,204.[312] Of this amount, we estimate that $1,195,000 is one-time computer

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310 112 -9 = 103. We received no comments on this estimate.

311 We expect that the function of completing Form ADV-E would be performed by compliance clerks at a cost of $63 per hour. The total cost would therefore be $7,056 (112 x $63 = $7,056). See supra note 266 for explanation of the hourly compliance clerk cost estimate.

312 $126,077,864 (total costs for complying amendments to rule 206(4)-2) + $193,284 (total costs for complying with amendments to Form ADV) + $7,056 (total costs for complying with amendments to Form ADV-E) = $126,278,204

system programming costs related to account statement legends, while the remainder will be recurred on an annual basis.

VI. FINAL REGULATORY FLEXIBILITY ANALYSIS

The Commission has prepared the following Final Regulatory Flexibility Analysis regarding rule 206(4)-2 in accordance with section 3(a) of the Regulatory Flexibility Act.[313] We prepared an Initial Regulatory Flexibility Analysis ("IRFA") in conjunction with the Proposing Release in May 2009. A summary of that IRFA was published with the Proposing Release.[314]

A. Need for the Rule

Rule 206(4)-2, the custody rule, requires registered advisers to maintain their clients' assets with a qualified custodian, such as a broker-dealer or a bank. To enhance the protections afforded to clients' assets, we are adopting amendments to the rule to require all registered advisers that have custody of client assets, among other things: (i) to undergo an annual surprise examination by an independent public accountant to verify client assets; (ii) to have a reasonable basis, after due inquiry, for believing that the qualified custodian maintaining client funds and securities sends account statements directly to the advisory clients; and (iii) unless client assets are maintained by an independent custodian (i.e., a custodian that is not the adviser itself or a related person) to obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the PCAOB.

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313 5 U.S.C. 605(b).

314 See Proposing Release at Section VI.

We have designed the amendments to enhance the protections afforded to clients when their advisers have custody of client assets. We believe that the surprise examination requirement will deter fraudulent activities by advisers. Moreover, an independent public accountant may identify misuse that clients have not, which would result in the earlier detection of fraudulent activities and reduce resulting client losses.

The amendments adopted today provide that an adviser is deemed to have custody of client assets held by related persons. Related person custody arrangements can present higher risks to advisory clients than those that maintain assets with an independent custodian. We were concerned that the surprise examination alone would not adequately address custodial risks associated with self or related person custody because the independent public accountant seeking to verify client assets would rely on custodial reports issued by the adviser or the related person. To address these risks, we are adopting a requirement that a registered adviser obtain, or receive from its related person, an annual internal control report, which would include an opinion from an independent public accountant with respect to the adviser's or related person's custody controls.

B. Significant Issues Raised by Public Comment

In the Proposing Release, we requested comment on the IRFA. We received a number of comments related to the impact of our proposal on small advisers. They argued that the proposed amendments to the rule, particularly those that would have imposed the surprise examination requirement on advisers that have custody solely because of their authority to deduct advisory fees, would be disproportionately expensive for, and would impose an undue regulatory burden on, smaller firms.[315]

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[315] Mallon P.C. Letter (asserting that the requirement would cost 10 percent of smaller firms' gross income). See also CAS Letter; Consortium Letter; Cornell Letter; Form Letter D;

We are sensitive to the burdens our rule amendments will have on small advisers. We believe that the amendments to the custody rule we are adopting today will alleviate many of the commenters' concerns regarding small advisers. In particular, as described above, we have provided an exception from the surprise examination requirement for advisers who have custody because they have authority to deduct advisory fees from client accounts. Moreover, for small advisers still subject to the surprise examination requirement, the revised guidance for accountants modernizes the procedures for surprise examinations, which may reduce the burden on small advisers.[316]

C. Small Entities Subject to Rule

Under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year.[317]

The Commission estimates that as of November 2, 2009 approximately 73 SEC-registered investment advisers that have custody of client assets were small entities that

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FSI Letter; IAA Letter; NAPFA Letter; FPA Letter; Denk Letter. Some commenters argued that, at a minimum, it would force most small advisers to eliminate a convenient billing method chosen by many of their clients. ASG Letter; Cornell Letter; Form Letters C and D; FSI Letter; MarketCounsel Letter. Others urged us to consider that this proposal would likely drive many small advisers out of business, and would create a barrier to entry for others. Ameritrade Letter; IASBDA Letter; NAPFA Letter.

316 See Accounting Release.

will be subject to the surprise examination requirement under amended rule 206(4)-2(a)(4), and that no more than eight small entity advisers that have custody of client assets will be subject to the requirement of obtaining or receiving an internal control report under amended rule 206(4)-2(a)(6).[318]

D. Projected Reporting, Recordkeeping, and other Compliance Requirements

The rule amendments impose certain reporting, recordkeeping and compliance requirements on advisers, including small advisers. The rule requires advisers that are subject to the surprise examination to complete Form ADV-E and to maintain internal control reports in certain instances. In addition, under the amendments, each adviser that is required to undergo an annual surprise examination must enter into a written agreement with the independent public accountant that performs the surprise examination that specifies certain duties the accountant must perform as part of the surprise examination engagement. Investment advisers, under the proposed rule amendments, must maintain a copy of an internal control report that an adviser is required to obtain, or receive from its related person, for five years from the end of the fiscal year in which the internal control report is finalized.

We estimate that a total of 1,859 advisers will be subject to the surprise examination requirement, of which 337 advisers will be subject to the surprise examination with respect to 100 percent of their clients and will each spend an average of \$125,000 annually,[319] and 1,522 will be subject to the surprise examination with respect

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[317] 17 CFR 275.0-7(a).

[318] Based on IARD data.

[319] See supra note 206 and accompanying text for explanation of the estimate.

to 5 percent of their clients. Of the 1,522 advisers, 262 medium-sized advisers will each spend an average of $20,000 annually,[320] and 1,260 small-sized advisers will each spend an average of $10,000 annually.[321] The advisers subject to the surprise examination that fall into the definition of "small entities" under section 3(a) of the Regulatory Flexibility Act are among the smallest within the small-sized advisers group, with an average of fewer than 6 clients whose accounts would be subject to the surprise examination requirement.[322] As a result, the accounting fees for the surprise examination conducted on the client accounts at these advisers may be lower than our estimated average cost of $10,000.[323] As a result, the potential impact of the amendments on these small entities due to the surprise examination requirement should not be substantial.

We also estimate that, on average, an internal control report will cost approximately $250,000 per year, but would vary based on the size and services offered by the qualified custodian. As stated above, we estimate that no more than eight small entity advisers will be subject to the internal control report requirement, half of which will obtain the report and the other half will receive the report from a related person. We

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320 These advisers report a larger number of clients than the average number of clients for the subset of advisers that are subject to the surprise examination for only a portion (estimated at 5%) of their clients.

321 These advisers report a smaller number of clients than the average number of clients for the subset of advisers that are subject to the surprise examination for only a portion (estimated at 5%) of their clients.

322 Based on IARD data, we estimate that more than half (43) of the 73 small advisers will be subject to the surprise examination with respect to no more than 6 clients.

323 For the four small entity advisers that may be subject to the surprise examination with respect to 100% of their clients, we believe the cost will be significantly less than the $125,000 annual fee estimated for the 337 advisers. Based on IARD data, we estimate that the average number of clients for these advisers would be 120 rather than the 2,315 we estimate for other advisers that are in the same group. See supra note 176 and accompanying text for explanation of our estimate of average number of clients for the 337 advisers.

believe that the cost of an internal control report for the four small entity advisers that must obtain one will be lower than the estimated $250,000 because of the small scale of their businesses. Alternatively, these advisers may simply advise their clients to select independent qualified custodians so that they will not be subject to the requirement of obtaining an internal control report.

E. Agency Action to Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the rule amendments, the Commission considered the following alternatives: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rule, or any part thereof, for such small entities.

Regarding the first and fourth alternatives, we do not believe that differing compliance or reporting requirements or an exemption from coverage of the rule amendments, or any part thereof, for small entities, would be appropriate or consistent with investor protection. Because the protections of the Advisers Act are intended to apply equally to clients of both large and small advisory firms, it would be inconsistent with the purposes of the Act to specify different requirements for small entities under the amendments.

Regarding the second alternative, the amendments clarify when an investment adviser, including a small adviser, has custody. In addition, we are providing updated guidance for accountants that modernize the procedures for the surprise examination and should provide clarification to investment advisers, including small entities, and accountants on certain issues regarding the surprise examination. We also have endeavored to consolidate and simplify the rule, by adding new definitions to the rule.

Regarding the third alternative, we do not consider using performance rather than design standards to be consistent with our statutory mandate of investor protection with respect to custody of client assets by investment advisers.

VII. EFFECTS ON COMPETITION, EFFICIENCY AND CAPITAL FORMATION

We are adopting amendments to rule 204-2, Part 1A of Form ADV and Form ADV-E, in part, pursuant to our authority under Section 204. Section 204 requires the Commission, when engaging in rulemaking pursuant to that authority, to consider whether the rule is "necessary or appropriate in the public interest or for the protection of investors."[324] Section 202(c)(1) of the Advisers Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[325] In the Proposing Release, we solicited comment on whether, if adopted, the proposed rule and form amendments would promote efficiency, competition and capital

324 15 U.S.C. 80b-4(a).

325 15 U.S.C. 80b-2(c). We are adopting amendments to rule 206(4)-2 pursuant to our authority set forth in Sections 206(4) and 211(a) of the Advisers Act, neither of which requires us to consider the factors indentified in Section 202(c). Analysis of the effects of these amendments is contained in Sections IV, V, and VI above.

formation. We further encouraged commenters to provide empirical data to support their views on any burdens on efficiency, competition or capital formation that might result from adoption of the proposed amendments. We did not receive any empirical data in this regard concerning the proposed amendments. We received some general comments asserting that the proposed amendments to require a surprise examination for advisers with custody of client assets as a result of deducting advisory fees from client accounts would have a significant adverse impact on competition.[326]

We believe the amendments we are adopting today to rule 204-2, Part 1A of Form ADV and Form ADV-E in connection with amendments to rule 206(4)-2, which are substantively similar to those we proposed, will promote efficiency and competition, but have little or no effect on capital formation.

The amendments to Part 1A of Form ADV are designed to provide us with additional details concerning the custody practices of advisers registered with the Commission, and to provide additional data to assist in our risk-based examination program. Under the amendments to Form ADV-E, the form and attached accountant's certificate will be filed electronically on the IARD system. In addition, the rule requires the accountant performing an annual surprise examination to, upon the accountant's termination or dismissal, or removal from consideration for reappointment, file Form ADV-E within 4 business days accompanied by a statement explaining any problems relating to examination scope or procedure that contributed to the resignation, dismissal,

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326 See, e.g., ASG Letter; Ameritrade Letter. The amended rule excludes from the surprise examination requirement advisers that have custody of client assets because of deducting advisory fees from client accounts. See amended rule 206(4)-2(b)(3).

removal, or other termination. Both Part 1A of From ADV and Form ADV-E will be available to the public on the Commission's web site.

Public availability of more detailed disclosure of advisers' custodial practices will permit investors to use this information together with other information they obtain from Form ADV in making more informed decisions about whether to hire or retain a particular adviser. A more informed investing public will create a more efficient marketplace and strengthen competition among advisers. Moreover, the electronic filing requirements are expected to expedite and simplify the process of filing Form ADV-E and attached accountant's certificate with the Commission, thus further improving efficiency. We believe, however, that the amendments are unrelated to, and will have little or no effect on, capital formation.

We are amending rule 204-2 to require (i) that, if an independent custodian does not maintain client assets but the adviser or a related person instead serves as a qualified custodian for client funds or securities under the rule in connection with advisory services the adviser provides to clients, the adviser must maintain a copy of any internal control report obtained or received pursuant to amended rule 206(4)-2(a)(6), and (ii) the memorandum describing the basis upon which the adviser determined that the presumption that a related person is not operationally independent was overcome, pursuant to amended rule 206(4)-2(d)(5) for five years from the end of the fiscal year in which, as applicable, the internal control report or memorandum is finalized.[327] The

[327] Rule 206(4)-2 requires that if an independent custodian does not maintain client assets but the adviser or a related person instead serves as a qualified custodian for client funds or securities under the rule in connection with advisory services the adviser provides to clients, the adviser must obtain, or receive from the related person, no less frequently than once each calendar year an internal control report, which includes an opinion from

amendment is designed to provide our examiners important information about the safeguards in place and assess custody-related risks at an adviser or a related person that maintains client assets. We believe that these amendments will not materially increase the compliance burden on advisers under rule 204-2 and thus will not affect competition, efficiency and capital formation.

VIII. STATUTORY AUTHORITY

We are adopting amendments to rule 206(4)-2 (17 CFR 275.206(4)-2) pursuant to our authority set forth in sections 206(4) and 211(a) of the Advisers Act (15 U.S.C. 80b-6(4) and 80b-11(a)). We are adopting amendments to rule 204-2 pursuant to the authority set forth in sections 204 and 211 of the Advisers Act (15 U.S.C. 80b-4 and 80b-11). We are adopting amendments to Part 1 of Form ADV (17 CFR 279.1) pursuant to our authority set forth in sections 203(c)(1), 204, and 211(a) of the Advisers Act (15 U.S.C. 80b-3(c)(1), 80b-4 and 80b-11(a)). We are adopting amendment to Form ADV-E (17 CFR 279.8) pursuant to our authority set forth in sections 204, 206(4), and 211(a) of the Advisers Act (15 U.S.C. 80b-4, 80b-6(4), and 80b-11(a)).

LIST OF SUBJECTS IN 17 CFR PARTS 275 AND 279

Reporting and recordkeeping requirements, Securities.

TEXT OF RULE AND FORM AMENDMENTS

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

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an independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets. See amended rule 206(4)-2(a)(6)(ii).

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

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

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

* * * * *

2. Section 275.204-2 is amended by:

a. Removing "in effect, and" at the end of paragraph (a)(17)(i) and adding in its place "in effect;" ;

b. Removing the period at the end of paragraph (a)(17)(ii) and adding in its place a semicolon;

c. Adding paragraph (a)(17)(iii); and

d. Adding paragraph (b)(5).

The addition reads as follows:

§ 275.204-2 Books and records to be maintained by investment advisers.

(a) * * *

(17) * * *

(iii) A copy of any internal control report obtained or received pursuant to § 275. 206(4)-2(a)(6)(ii).

(b) * * *

(5) A memorandum describing the basis upon which you have determined that the presumption that any related person is not operationally independent under § 275.206(4)-2(d)(5) has been overcome.

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3. Section 275.206(4)-2 is revised to read as follows:

§ 275.206(4)-2 Custody of funds or securities of clients by investment advisers.

(a) Safekeeping required. If you are an investment adviser registered or required to be registered under section 203 of the Act (15 U.S.C. 80b-3), it is a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for you to have custody of client funds or securities unless:

(1) Qualified custodian. A qualified custodian maintains those funds and securities:

(i) In a separate account for each client under that client's name; or

(ii) In accounts that contain only your clients' funds and securities, under your name as agent or trustee for the clients.

(2) Notice to clients. If you open an account with a qualified custodian on your client's behalf, either under the client's name or under your name as agent, you notify the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, promptly when the account is opened and following any changes to this information. If you send account statements to a client to which you are required to provide this notice, include in the notification provided to that client and in any subsequent account statement you send that client a statement urging the client to compare the account statements from the custodian with those from the adviser.

(3) Account statements to clients. You have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of your clients for which it maintains funds or securities, identifying the amount of

funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period.

(4) Independent verification. The client funds and securities of which you have custody are verified by actual examination at least once during each calendar year, except as provided below, by an independent public accountant, pursuant to a written agreement between you and the accountant, at a time that is chosen by the accountant without prior notice or announcement to you and that is irregular from year to year. The written agreement must provide for the first examination to occur within six months of becoming subject to this paragraph, except that, if you maintain client funds or securities pursuant to this section as a qualified custodian, the agreement must provide for the first examination to occur no later than six months after obtaining the internal control report. The written agreement must require the accountant to:

(i) File a certificate on Form ADV-E (17 CFR 279.8) with the Commission within 120 days of the time chosen by the accountant in paragraph (a)(4) of this section, stating that it has examined the funds and securities and describing the nature and extent of the examination;

(ii) Upon finding any material discrepancies during the course of the examination, notify the Commission within one business day of the finding, by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations; and

(iii) Upon resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed, file within four business days Form ADV-E accompanied by a statement that includes:

(A) The date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant; and

(B) An explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination.

(5) Special rule for limited partnerships and limited liability companies. If you or a related person is a general partner of a limited partnership (or managing member of a limited liability company, or hold a comparable position for another type of pooled investment vehicle), the account statements required under paragraph (a)(3) of this section must be sent to each limited partner (or member or other beneficial owner).

(6) Investment advisers acting as qualified custodians. If you maintain, or if you have custody because a related person maintains, client funds or securities pursuant to this section as a qualified custodian in connection with advisory services you provide to clients:

(i) The independent public accountant you retain to perform the independent verification required by paragraph (a)(4) of this section must be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules; and

(ii) You must obtain, or receive from your related person, within six months of becoming subject to this paragraph and thereafter no less frequently than once each calendar year a written internal control report prepared by an independent public accountant:

(A) The internal control report must include an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, and are suitably designed and are operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either you or a related person on behalf of your advisory clients, during the year;

(B) The independent public accountant must verify that the funds and securities are reconciled to a custodian other than you or your related person; and

(C) The independent public accountant must be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules.

(7) Independent representatives. A client may designate an independent representative to receive, on his behalf, notices and account statements as required under paragraphs (a)(2) and (a)(3) of this section.

(b) Exceptions. (1) Shares of mutual funds. With respect to shares of an open-end company as defined in section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-5(a)(1)) ("mutual fund"), you may use the mutual fund's transfer agent in lieu of a qualified custodian for purposes of complying with paragraph (a) of this section.

(2) Certain privately offered securities. (i) You are not required to comply with paragraph (a)(1) of this section with respect to securities that are:

(A) Acquired from the issuer in a transaction or chain of transactions not involving any public offering;

(B) Uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and

(C) Transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

(ii) Notwithstanding paragraph (b)(2)(i) of this section, the provisions of this paragraph (b)(2) are available with respect to securities held for the account of a limited partnership (or a limited liability company, or other type of pooled investment vehicle) only if the limited partnership is audited, and the audited financial statements are distributed, as described in paragraph (b)(4) of this section.

(3) Fee deduction. Notwithstanding paragraph (a)(4) of this section, you are not required to obtain an independent verification of client funds and securities maintained by a qualified custodian if:

(i) you have custody of the funds and securities solely as a consequence of your authority to make withdrawals from client accounts to pay your advisory fee; and

(ii) if the qualified custodian is a related person, you can rely on paragraph (b)(6) of this section.

(4) Limited partnerships subject to annual audit. You are not required to comply with paragraphs (a)(2) and (a)(3) of this section and you shall be deemed to have complied with paragraph (a)(4) of this section with respect to the account of a limited partnership (or limited liability company, or another type of pooled investment vehicle) that is subject to audit (as defined in rule 1-02(d) of Regulation S-X (17 CFR 210.1-02(d)):

(i) At least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year;

(ii) By an independent public accountant that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules; and

(iii) Upon liquidation and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) promptly after the completion of such audit.

(5) Registered investment companies. You are not required to comply with this section (17 CFR 275.206(4)-2) with respect to the account of an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 to 80a-64).

(6) Certain Related Persons. Notwithstanding paragraph (a)(4) of this section, you are not required to obtain an independent verification of client funds and securities if:

(i) you have custody under this rule solely because a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients; and

(ii) your related person is operationally independent of you.

(c) Delivery to Related Person. Sending an account statement under paragraph (a)(5) of this section or distributing audited financial statements under paragraph (b)(4) of this section shall not satisfy the requirements of this section if such account statements or financial statements are sent solely to limited partners (or members or other beneficial owners) that themselves are limited partnerships (or limited liability companies, or another type of pooled investment vehicle) and are your related persons.

(d) Definitions. For the purposes of this section:

(1) Control means the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise. Control includes:

(i) Each of your firm's officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control your firm;

(ii) A person is presumed to control a corporation if the person:

(A) Directly or indirectly has the right to vote 25 percent or more of a class of the corporation's voting securities; or

(B) Has the power to sell or direct the sale of 25 percent or more of a class of the corporation's voting securities;

(iii) A person is presumed to control a partnership if the person has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the partnership;

(iv) A person is presumed to control a limited liability company if the person:

(A) Directly or indirectly has the right to vote 25 percent or more of a class of the interests of the limited liability company;

(B) Has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the limited liability company; or

(C) Is an elected manager of the limited liability company; or

(v) A person is presumed to control a trust if the person is a trustee or managing agent of the trust.

(2) <u>Custody</u> means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. You have custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients. Custody includes:

(i) Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them;

(ii) Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and

(iii) Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.

(3) <u>Independent public accountant</u> means a public accountant that meets the standards of independence described in rule 2-01(b) and (c) of Regulation S-X (17 CFR 210.2-01(b) and (c)).

(4) <u>Independent representative</u> means a person that:

(i) Acts as agent for an advisory client, including in the case of a pooled investment vehicle, for limited partners of a limited partnership (or members of a limited liability company, or other beneficial owners of another type of pooled investment vehicle) and by law or contract is obliged to act in the best interest of the advisory client or the limited partners (or members, or other beneficial owners);

(ii) Does not control, is not controlled by, and is not under common control with you; and

(iii) Does not have, and has not had within the past two years, a material business relationship with you.

(5) Operationally independent: for purposes of paragraph (b)(6) of this section, a related person is presumed not to be operationally independent unless each of the following conditions is met and no other circumstances can reasonably be expected to compromise the operational independence of the related person: (i) client assets in the custody of the related person are not subject to claims of the adviser's creditors; (ii) advisory personnel do not have custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person.

(6) Qualified custodian means:

(i) A bank as defined in section 202(a)(2) of the Advisers Act (15 U.S.C. 80b-2(a)(2)) or a savings association as defined in section 3(b)(1) of the Federal Deposit

Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811);

(ii) A broker-dealer registered under section 15(b)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b)(1)), holding the client assets in customer accounts;

(iii) A futures commission merchant registered under section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)), holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and

(iv) A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.

(7) Related person means any person, directly or indirectly, controlling or controlled by you, and any person that is under common control with you.

PART 279 – FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940

4. The authority citation for Part 279 continues to read as follows:

Authority: The Investment Advisers Act of 1940, 15 U.S.C. 80b-1, et seq.

5. Form ADV (referenced in § 279.1) is amended by:

a. In the General Instructions, revising the first bullet and last paragraph of instruction 4;

b. In Part 1A, revising the last paragraph of Item 7.A. and revising Item 9; and

c. In Schedule D, revising Section 7.A., and adding Sections 9.C. and 9.D.

The revisions read as follows:

Note: The text of Form ADV does not and this amendment will not appear in the Code of Federal Regulations.

Form ADV

* * * * *

Form ADV: General Instructions

* * * * *

4. * * *

- information you provided in response to Items 1, 3, 9 (except 9.A.(2), 9.B.(2), and 9.(E)), or 11 of Part 1A or Items 1, 2.A. through 2.F., or 2.I. of Part 1B becomes inaccurate in any way;

* * * * *

If you are submitting an other-than-annual amendment, you are not required to update your responses to Items 2, 5, 6, 7, 9.A.(2), 9.B.(2), 9.E., or 12 of Part 1A or Items 2.H. or 2.J. of Part 1B even if your responses to those items have become inaccurate. If you are amending Part II, do not file the amendment with the SEC.

* * * * *

Part 1A

* * * * *

Item 7 Financial Industry Affiliates

* * * * *

A. * * *

If you checked Items 7.A.(1) or (3), you must list on Section 7.A of Schedule D all your *related persons* that are investment advisers, broker-dealers, municipal securities dealers, or government securities broker or dealers.

* * * * *

Item 9 Custody

In this Item, we ask you whether you or a *related person* has *custody* of *client* assets and about your custodial practices.

A. (1) Do you have *custody* of any advisory *clients'*:

		Yes	No
(a)	cash or bank accounts?	☐	☐
(b)	securities?	☐	☐

If you are registering or registered with the SEC, answer "No" to Item 9.A.(1)(a) and (b) if you have custody solely because (i) you deduct your advisory fees directly from your clients' accounts, or (ii) a related person maintains client funds or securities as a qualified custodian but you have overcome the presumption that you are not operationally independent (pursuant to Advisers Act rule 206(4)(2)-(d)(5)) from the related person.

(2) If you checked "yes" to Item 9.A.(1)(a) or (b), what is the amount of *client* funds and securities and total number of *clients* for which you have *custody*:

U.S. Dollar Amount	Total Number of *Clients*
(a) $_______________	(b) _____________

If your related person serves as qualified custodian of client assets, do not include the amount of those assets and the number of those clients in your response to Item 9.A.(2). Instead, include that information in your response to Item 9.B.(2).

B. (1) Do any of your *related persons* have *custody* of any of your advisory *clients'*:

		Yes	No
(a)	cash or bank accounts?	☐	☐
(b)	securities?	☐	☐

You are required to answer this item regardless of how you answered Item 9.A.(1)(a) or (b).

(2) If you checked "yes" to Item 9.B.(1)(a) or (b), what is the amount of *client* funds and securities and total number of *clients* for which your *related persons* have *custody*:

U.S. Dollar Amount	Total Number of *Clients*
(a) $__________	(b) __________

C. If you or your *related persons* have *custody* of *client* funds or securities, check all the following that apply:

☐ (1) A qualified custodian(s) sends account statements at least quarterly to the investors in the pooled investment vehicle(s) you manage.

☐ (2) An independent public accountant audits annually the pooled investment vehicle(s) that you manage and the audited financial statements are distributed to the investors in the pools.

☐ (3) An independent public accountant conducts an annual surprise examination of *client* funds and securities.

☐ (4) An independent public accountant prepares an internal control report with respect to custodial services when you or your *related persons* are qualified custodians for *client* funds and securities.

If you checked Item 9.C.(2), C.(3) or C.(4), list in Section 9.C. of Schedule D the accountants that are engaged to perform the audit or examination or prepare an internal control report.

D. Do you or your *related persons* act as qualified custodians for your *clients* in connection with advisory services you provide to *clients*?

		Yes	No
(1)	you act as a qualified custodian	☐	☐
(2)	your related persons act as qualified custodians	☐	☐

If you checked "yes" to Item 9.D.(2), list in Section 9.D. of Schedule D all your related persons that act as qualified custodians for your clients in connection with advisory services you provide to clients (you do not have to list broker-dealers already identified as qualified custodians in Section 7.A. of Schedule D).

E. If you are filing your annual updating amendment and you were subject to a surprise examination by an independent public accountant during your last fiscal year, provide the date (MM/YYYY) the examination commenced: __________

* * * * *

Schedule D

* * * * *

SECTION 7.A. Affiliated Investment Advisers and Broker-Dealers

You must complete the following information for each *related person* investment adviser and broker-dealer. You must complete a separate Schedule D Page 3 for each listed *related person*.

Check only one box: ☐ Add ☐ Delete ☐ Amend

Legal Name of *Related Person*:

____

Primary Business Name of *Related Person*:

____

Related person is (check only one box): ☐ Investment Adviser ☐ Broker-Dealer ☐ Dual (Investment Adviser and Broker-Dealer)

If the *related person* is a broker-dealer, is it a qualified custodian for your *clients* in connection with advisory services you provide to *clients*? Yes ☐ No ☐

If you are registering or registered with the SEC and you have answered "yes," have you overcome the presumption that you are not operationally independent (pursuant to Advisers Act rule 206(4)(2)-(d)(5)) from the *related person* broker-dealer, and thus are not required to obtain a surprise examination for your *clients'* funds or securities that are maintained at the *related person*?

Yes ☐ No ☐

Related Person Adviser's SEC File Number (if any) 801- ______________

Related Person's CRD Number (if any): ________________

* * * * *

SECTION 9.C. Independent Public Accountant

You must complete the following information for each independent public accountant engaged to perform a surprise examination, perform an audit of a pooled investment vehicle that you manage, or prepare an internal control report. You must complete a separate Schedule D Page 4 for each independent public accountant.

Check only one box: ☐ Add ☐ Delete ☐ Amend

(1) Name of the independent public accountant:

____

(2) The location of the independent public accountant's office responsible for the services provided:

(number and street)

(city) (state/country) (zip+4/postal code)

(3) Is the independent public accountant registered with the Public Company Accounting Oversight Board? Yes ☐ No ☐

(4) If yes to (3) above, is the independent public accountant subject to regular inspection by the Public Company Accounting Oversight Board in accordance with its rules? Yes ☐ No ☐

(5) The independent public accountant is engaged to:

A. ☐ audit a pooled investment vehicle
B. ☐ perform a surprise examination of *client* assets
C. ☐ prepare an internal control report

(6) Does the report prepared by the independent public accountant that audited the pooled investment vehicle or that examined internal controls contain an unqualified opinion?
Yes ☐ No ☐

SECTION 9.D. *Related Person* Qualified Custodian

You must complete the following information for each of your *related persons* that acts as a qualified custodian for your *clients* in connection with advisory services you provide to *clients* (you do not have to list broker-dealers already identified as qualified custodians in Section 7.A. of Schedule D). You must complete a separate Schedule D Page 5 for each listed *related person*.

Check only one box: ☐ Add ☐ Delete ☐ Amend

Legal Name of *Related Person*:

Primary Business Name of *Related Person*:

The location of the *related person*'s office responsible for custody of your *clients*' assets:

(number and street)

(city) (state/country) (zip+4/postal code)

Related Person is (check only one box):
☐ U.S. Bank or Savings Association

☐ Futures Commission Merchant
☐ Foreign Financial Institution

If you are registering or registered with the SEC, have you overcome the presumption that you are not operationally independent (pursuant to Advisers Act rule 206(4)(2)-(d)(5)) from the *related person* qualified custodian, and thus are not required to obtain a surprise examination for your *clients'* funds or securities that are maintained at the *related person*? Yes ☐ No ☐

* * * * *

6. Form ADV-E (referenced in § 279.8) is amended by revising the instructions to the Form.

The revisions read as follows:

Note: The text of Form ADV-E does not and this amendment will not appear in the Code of Federal Regulations.

Form ADV-E

* * * * *

INSTRUCTIONS

This Form must be completed by investment advisers that have custody of client funds or securities and that are subject to an annual surprise examination. This Form may *not* be used to amend any information included in an investment adviser's registration statement (*e.g.,* business address).

Investment Adviser

1. All items must be completed by the investment adviser.

2. Give this Form to the independent public accountant that, in compliance with rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Act") or applicable state law, examines client funds and securities in the custody of the investment adviser within

120 days of the time chosen by the accountant for the surprise examination and upon such accountant's resignation or dismissal from, or other termination of, the engagement, or if the accountant removes itself or is removed from consideration for being reappointed.

Accountant

3. The independent public accountant performing the surprise examination must submit (i) this Form and a certificate of accounting required by rule 206(4)-2 under the Act or applicable state law within 120 days of the time chosen by the accountant for the surprise examination, and (ii) this Form and a statement, within four business days of its resignation or dismissal from, or other termination of, the engagement, or removing itself or being removed from consideration for being reappointed, that includes (A) the date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant, and (B) an explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination:

(a) By mail, until the Investment Adviser Registration Depository ("IARD") accepts electronic filing of the Form, to the Securities and Exchange Commission or appropriate state securities administrators. File the original and one copy with the Securities and Exchange Commission's principal office in Washington, DC at the address on the top of this Form, and one copy with the regional office for the region in which the investment adviser's principal business operations are conducted, or one copy with the appropriate state administrator(s), if applicable; or

(b) By electronic filing of the certificate of accounting and statement regarding resignation, dismissal, other termination, or removal from consideration for reappointment on the IARD, when the IARD accepts electronic filing of the Form.

* * * * *

By the Commission.

Florence E. Harmon

Florence E. Harmon
Deputy Secretary

December 30, 2009

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 276

[Release Nos. IA-2969; FR-81]

Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation.

SUMMARY: The Securities and Exchange Commission (the "Commission") is publishing interpretive guidance for independent public accountants in connection with the adoption of amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule"). This guidance provides direction with respect to the independent verification and internal control report as required under the amended Custody Rule.

DATES: Effective Date [Insert 60 days after publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: General questions about this release should be referred to Bryan J. Morris, Assistant Chief Accountant, Jaime L. Eichen, Assistant Chief Accountant, or Richard F. Sennett, Chief Accountant at (202) 551-6918 or IMOCA@sec.gov, Office of the Chief Accountant, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-8626. Questions about Rule 206(4)-2 should be directed to staff of the Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549 at (202) 551-6787 or IArules@sec.gov.

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SUPPLEMENTARY INFORMATION:

I. Background

Rule 206(4)-2(a) under the Investment Advisers Act of 1940 (the "Act") provides, among other things, that it is a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of Section 206(4) of the Act for any investment adviser registered (or required to be registered) under Section 203 of the Act (herein "investment adviser") to have custody of client funds or securities unless:

(1) a qualified custodian maintains those funds and securities in a separate account for each client under that client's name; or in accounts that contain only clients' funds and securities, under the investment adviser's name as agent or trustee for the clients;

(2) clients are notified promptly in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, when an account is opened by an investment adviser on a client's behalf and following any changes to this information; and

(3) the investment adviser has a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of its clients for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period.

Rule 206(4)-2(a) generally requires that client funds and securities of which an investment adviser has custody under the rule be verified by actual examination at least once during each calendar year by an independent public accountant[1] ("accountant"), pursuant to a written agreement, between the investment adviser and the accountant, at a time that is chosen by the accountant without prior notice or announcement to the investment adviser and that is irregular from year to year.

II. Independent Verification of Funds and Securities

The objective of the accountant's examination[2] is to verify that client funds and securities of which an investment adviser has custody are held by a qualified custodian in a separate account for each client under that client's name, or in accounts that contain only clients' funds and securities, under the investment adviser's name as agent or trustee for the clients. The accountant should obtain from the investment adviser records that detail client funds and securities of which the investment adviser has custody and the identification of the qualified custodian(s) of those funds and securities.[3] The accountant should also obtain records of accounts that were closed during the period or that have a zero balance as of the date of the examination.

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1 If the investment adviser itself or a related person maintains clients' funds and securities as qualified custodian, the independent public accountant must be registered with, and subject to inspection by, the Public Company Accounting Oversight Board ("PCAOB"). See Rule 206(4)-2(a)(6)(i).

2 The examination is a compliance examination to be conducted in accordance with American Institute of Certified Public Accountants' ("AICPA") attestation standards. See AT Section 601, Compliance Attestation ("AT 601").

3 Rule 204-2(b) under the Act requires that an investment adviser who has custody or possession of funds and securities of any client must record all transactions for such client in a journal and in separate ledger accounts for each client and must maintain copies of confirmations of all transactions in such accounts and a position record for each security in which a client has an interest. Rule 204-2(h) of the Act indicates that records maintained and preserved in compliance with Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 (i.e., records maintained by a broker-dealer) can be deemed to satisfy the requirements of Rule 204-2(b), provided that they are substantially the same types of records. See Rule 204-2(b) and Rule 204-2(h) under the Act.

For a sample of client accounts, the accountant should obtain records of the purchases, sales, contributions, withdrawals and any other debits or credits to each selected client's account occurring since the date of the last examination. The accountant's procedures to meet the objective of the examination should normally include, but are not limited to, the following with respect to each selected client account:

- confirmation with the qualified custodian(s) of client funds and securities as of the date of the examination and that the client's funds and securities are held in either a separate account under the client's name or in accounts under the name of the investment adviser as agent or trustee for clients;
- confirmation with the client of funds and securities held in the account as of the date of the examination and contributions and withdrawals of funds and securities to and from the account since the date of the last examination; where confirmation replies are not received, the accountant should perform alternative procedures; and
- reconciliation of confirmations received and other evidence obtained to the investment adviser's records.

Privately offered securities

Rule 206(4)-(2)(b)(2) generally exempts privately offered securities from the qualified custodian requirements established under Rule 206(4)-(2)(a)(1).[4] Under the rule, a privately offered security is a security that is:

(1) acquired from the issuer in a transaction or chain of transactions not involving any public offering;

[4] The exemption provided by the rule is available with respect to securities held for the account of a limited partnership (or a limited liability company, or other type of pooled investment vehicle) only if the limited partnership is audited, and the audited financial statements are distributed, as described in paragraph (b)(4) of the rule.

(2) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and

(3) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

The accountant's verification procedures with respect to any privately offered security selected for testing should include confirmation with the issuer of or counterparty to the security, or, where replies are not received, alternative procedures.

Reporting – Independent Verification

The accountant's examination report should include an opinion as to whether, with respect to the rules under the Act, the investment adviser was in compliance, in all material respects, with paragraph (a)(1) of Rule 206(4)-2 as of the examination date and had been complying with Rule 204-2(b) during the period since the prior examination date. The accountant should identify the date as of which the examination was made within the report.

Pursuant to the written agreement required under Rule 206(4)-2(a)(4), upon finding any material discrepancy during the course of the examination, the accountant should notify the Commission within one business day of the finding, by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations. For purposes of this examination, a material discrepancy is material non-compliance with the provisions of either Rule 206(4)-2 or Rule 204-2(b) under the Act.[5]

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5 Reporting on material non-compliance is discussed within AT 601 of the AICPA attestation standards. See AT 601.

Pursuant to the written agreement required under Rule 206(4)-2(a)(4), the examination should be completed and the resulting examination report should be filed on Form ADV-E by the accountant within 120 days of the time chosen by the accountant. The accountant should also file Form ADV-E with the Commission upon resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed within four business days. Such filing should be accompanied by a statement that includes:

(1) the date of such resignation, dismissal, removal, or other termination, and the name, address, and contact information of the accountant; and

(2) an explanation of any problems relating to examination scope or procedure that contributed to such resignation, dismissal, removal, or other termination.

III. Internal Control Report

Rule 206(4)-2(a)(6) establishes additional requirements for an investment adviser that itself, or its related person, maintains client funds or securities as a qualified custodian in connection with advisory services provided to clients. Such an investment adviser must at least once each calendar year obtain or receive from its related person an internal control report related to its or its affiliates' custody services, including the safeguarding of funds and securities, prepared by an independent public accountant that is registered with, and subject to inspection by, the PCAOB.[6]

The objective of the examination supporting the internal control report is to obtain reasonable assurance that the qualified custodian's controls have been placed in operation

[6] A Type II SAS 70 Report conducted in accordance with AU Section 324, Service Organizations ("AU 324") of the AICPA auditing standards would be sufficient to satisfy the requirements of the internal control report. In addition to the Type II SAS 70 Report, an examination on internal control conducted in accordance with AT 601 would also be sufficient.

as of a specific date, and are suitably designed and are operating effectively to meet control objectives related to custody of funds and securities during the period specified. The internal control report should address control objectives and associated controls related to the areas of client account setup and maintenance, authorization and processing of client transactions, security maintenance and setup, processing of income and corporate action transactions, reconciliation of funds and securities to depositories and other unaffiliated custodians, and client reporting. Control objectives addressing these areas should include –

- Documentation for the opening and modification of client accounts is received, authenticated, and established completely, accurately, and timely on the applicable system.
- Client transactions, including contributions and withdrawals, are authorized and processed in a complete, accurate, and timely manner.
- Trades are properly authorized, settled, and recorded completely, accurately, and timely in the client account.
- New securities and changes to securities are authorized and established in a complete, accurate and timely manner.
- Securities income and corporate action transactions are processed to client accounts in a complete, accurate, and timely manner.
- Physical securities are safeguarded from loss or misappropriation.
- Cash and security positions are reconciled completely, accurately and on a timely basis between the custodian and depositories.

- Account statements reflecting cash and security positions are provided to clients in a complete, accurate and timely manner.

Rule 206(4)-2(a)(6)(ii)(B) states that, as part of the internal control report, the independent public accountant must verify that funds and securities are reconciled to a custodian other than the adviser or its related person (for example, the Depository Trust Corporation). The accountant's tests of the custodian's reconciliation(s) should include either direct confirmation, on a test basis, with unaffiliated custodians or other procedures designed to verify that the data used in reconciliations performed by the qualified custodian is obtained from unaffiliated custodians and is unaltered.

Reporting - Internal Control Report

The accountant's internal control report should identify the control objectives included within the scope of the examination and include the accountant's opinion as to whether controls have been placed in operation as of the specific date, and are suitably designed and are operating effectively to meet the identified control objectives during the specified period. The report should also describe the nature, timing, extent and results of the accountant's procedures performed to verify that funds and securities are reconciled to depositories and other unaffiliated custodians.[7]

IV. Relationship between Independent Verification and Internal Control Report

When performing an independent verification of client funds and securities for an investment adviser that itself, or its related person, maintains custody as a qualified custodian, the accountant should obtain a copy of the most recently issued internal control report and determine whether there are any findings in the internal control report

[7] Paragraph .62 of AU 324 discusses reporting on substantive procedures as part of a Type II SAS 70 report. See AU 324.

that would affect the nature and extent of his or her procedures. If findings within the internal control report indicate information provided by the qualified custodian may not be reliable, the accountant should consider whether the circumstances warrant the issuance of a qualified or adverse opinion, or a disclaimer of opinion.

If a significant period of time has elapsed since the issuance of the internal control report, the accountant should perform appropriate procedures to determine whether there have been significant changes to the procedures and controls related to custody at the qualified custodian since the date of the report. If significant changes have occurred, the accountant should perform procedures to update his or her understanding of whether the controls at the qualified custodian have been placed in operation, are suitably designed, and are operating effectively to meet the identified control objectives, as appropriate in the circumstances. The accountant can perform these procedures directly or can request that the accountant that prepared the internal control report perform such procedures.

V. Codification Update

The "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1 (April 15, 1982) [47 FR 21028] is updated by replacing Section 404.01.b. Investment Advisers with the text in Sections I, II, III, and IV of this release. The Codification is a separate publication of the Commission. It will not be published in the Federal Register/Code of Federal Regulations.

List of Subjects

17 CFR Part 276

Reporting and recordkeeping requirements, Securities.

Amendments to the Code of Federal Regulations

For the reasons set out in the preamble, the Commission is amending title 17, chapter II of the Code of Federal Regulations as set forth below:

PART 276 - INTERPRETATIVE RELEASES RELATING TO THE INVESTMENT ADVISERS ACT OF 1940 AND GENERAL RULES AND REGULATIONS THEREUNDER

Part 276 is amended by adding Release No. IA-2969 and the release date of December 30, 2009 to the list of interpretive releases.

By the Commission.

Florence E. Harmon

Florence E. Harmon
Deputy Secretary

Dated: December 30, 2009