

SECURITIES AND EXCHANGE COMMISSION

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

MARY L. SCHAPIRO, CHAIRMAN

KATHLEEN L. CASEY, COMMISSIONER

ELISSE B. WALTER, COMMISSIONER

LUIS A. AGUILAR, COMMISSIONER

TROY A. PAREDES, COMMISSIONER

(44 Documents)

*Commissioner Aguilar  
not participating*

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 62025 / May 4, 2010

ADMINISTRATIVE PROCEEDING  
File No. 3-13877

In the Matter of  
  
GOLDMAN SACHS EXECUTION &  
CLEARING, L.P.  
  
Respondent.

ORDER INSTITUTING ADMINISTRATIVE  
AND CEASE-AND-DESIST PROCEEDINGS  
PURSUANT TO 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 Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Goldman Sachs Execution & Clearing, L.P. ("Respondent" or "GSEC").

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 Pursuant to 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 Respondent's Offer, the Commission finds that:

## Summary

1. These proceedings relate to GSEC's response to the Commission's September 17, 2008 emergency order enacting temporary Rule 204T to Regulation SHO ("Rule 204T" or the "Rule"). That Rule was an important part of the Commission's response to concerns about the effects of "naked" short selling upon securities prices.<sup>1</sup> The Rule, adopted as an interim final temporary rule on October 17, 2008, required participants of a registered clearing agency<sup>2</sup> to either deliver securities by a trade's settlement date or, in connection with short sales, immediately purchase or borrow securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the trading day following the settlement date.<sup>3</sup> GSEC initially responded to the Rule by implementing procedures that were inadequate in that they relied too heavily on individuals to perform manual tasks and calculations, without sufficient oversight or verification of accuracy. As a result, on certain occasions in December 2008 and January 2009 ("the relevant time period"), GSEC violated Rule 204T by failing to timely close out fail to deliver positions.

## Respondent

2. Goldman Sachs Execution & Clearing, L.P. is a broker-dealer based in Jersey City, New Jersey and has been registered with the Commission since 1948 pursuant to Section 15(b) of the Exchange Act. GSEC is a wholly-owned subsidiary of The Goldman Sachs Group, Inc., whose securities are registered with the Commission pursuant to Section 12(b) of the Exchange Act. Prior to January 2005, GSEC was known as Spear, Leeds & Kellogg, L.P.

## Background

3. Regulation SHO, compliance with which was required beginning in early 2005, was adopted by the Commission, in part, to regulate short sales.<sup>4</sup> One of the goals of Regulation SHO was to address problems associated with failures to deliver, including potentially abusive

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<sup>1</sup> A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. "Naked" short selling generally refers to selling short without borrowing or arranging to borrow the securities in time to make delivery within the three-day settlement period. As a result, the seller's clearing firm may fail to deliver securities when delivery is due.

<sup>2</sup> GSEC was a participant of a registered clearing agency for the purposes of Rule 204T. "Participant" of a registered clearing agency refers to "any person who uses a clearing agency to clear or settle securities transactions or to transfer, pledge, lend, or hypothecate securities. Such term does not include a person whose only use of a clearing agency is (A) through another person who is a participant or (B) as a pledgee of securities." See Exchange Act Section 3(a)(24).

<sup>3</sup> A "fail to deliver" occurs when a participant of a registered clearing agency is obligated, and fails, to deliver the securities to the clearing agency by settlement date. The resulting open position is referred to as a "fail position" or an "open fail."

<sup>4</sup> Exchange Act Release No. 34-50103 (July 28, 2004) ("Regulation SHO Adopting Release").

“naked” short selling. One way that Regulation SHO attempted to reach that goal was by the creation of a “close-out” requirement.<sup>5</sup> This requirement mandates that clearing firms must close out fail to deliver positions in threshold securities that have persisted for 13 consecutive settlement days by purchasing securities of like kind and quantity.<sup>6</sup>

4. In the spring and summer of 2008, securities markets experienced inordinately large fluctuations. On September 17, 2008, the Commission, concerned by the threat of sudden and excessive fluctuations in securities prices and disruption in the functioning of the securities markets, and in particular, by the possible effects of “naked” short selling upon securities prices, issued an emergency order pursuant to Section 12(k) of the Exchange Act enacting, among others, temporary Rule 204T to Regulation SHO.<sup>7</sup> On October 14, 2008, the Commission adopted Rule 204T as an interim final temporary rule, to be in effect from October 17, 2008 until July 31, 2009.<sup>8</sup>

5. Rule 204T required that participants of a registered clearing agency, such as GSEC, either deliver securities by settlement date or, in connection with short sales, purchase or borrow securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the trading day following the settlement date.<sup>9</sup> Therefore, fail to deliver positions resulting from short sales were required to be closed out by no later than the beginning of regular trading hours on the fourth day after the trade date (“T+4”). Fail to deliver positions resulting from long sales and from short sales due to *bona fide* market making activities, however, were given a two day extension for close-out, to no later than the beginning of regular trading hours on the sixth day after the trade date (“T+6”). If the participant did not comply with the Rule’s close-out requirement, then that firm or any broker-dealer from which it received trades for clearance and settlement was prohibited from selling short the security at issue unless it had previously borrowed or arranged to borrow the security (known as the “pre-borrow penalty”).

6. Many of GSEC’s customers are market makers. When a market maker is subject to the pre-borrow penalty, it may be difficult for that market maker to perform its duties, as short sales are commonly used as part of *bona fide* market making activities in a stock. Thus, when a market maker that is the sole market maker in a stock on a floor-based exchange is subject to the

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<sup>5</sup> See Rule 203(b)(3) of Regulation SHO.

<sup>6</sup> A “threshold security” is an equity security which has an aggregate fail to deliver position totaling 10,000 shares and equal to at least 0.5% of the issuer’s total shares outstanding for at least 5 consecutive settlement days. See Rule 203(c)(6) of Regulation SHO.

<sup>7</sup> Exchange Act Release No. 34-58572 (September 17, 2008).

<sup>8</sup> Exchange Act Release No. 34-58773 (October 17, 2008).

<sup>9</sup> On July 27, 2009, the Commission adopted Rule 204, which made Rule 204T permanent with limited changes. Therefore, the requirements of the Rule described above continue to apply to GSEC and other participants of registered clearing agencies.

pre-borrow penalty, that stock may be reallocated by the exchange to another market maker until the penalty ends. This reallocation could potentially result in disruption to the market in a particular stock.

7. Upon the Rule's release, GSEC implemented procedures designed to ensure its compliance with Rule 204T. Generally, this entailed tracking its delivery obligations to make sure that short sale fail positions were closed out by no later than the beginning of regular trading hours on T+4, while fail positions attributable to long sales and short sales resulting from market making activity were closed out by no later than the beginning of regular trading hours on the morning of T+6. These procedures were to a great extent performed manually. Ultimately, GSEC developed a system-based process in spring 2009.

8. During the relevant time period, each morning GSEC's Operations department created a spreadsheet which listed all T+4 and T+6 obligations that were coming due that day at market open. That information was sent to GSEC's Client Services department, which reduced the obligations by the amount of: borrowed stock; pre-fail credits;<sup>10</sup> market maker extensions; and other extensions.<sup>11</sup> The final close-out obligation information was then forwarded by Client Services to a trade execution group within GSEC, which entered purchase orders at market open. After those purchases were made, Client Services sent the information back to Operations to track the actions taken on that day's T+4 obligations and to calculate the amount of the potential close-out obligation on the corresponding T+6.

#### GSEC's Failure to Properly Close Out Positions

9. In December 2008 and January 2009, GSEC did not close out certain fail to deliver positions as required by Rule 204T, leaving both GSEC and its customers subject to the pre-borrow penalty.

##### **December 9, 2008**

10. On December 9, 2008, GSEC did not close out its fail to deliver positions in 22 securities at T+6. The procedure in place at GSEC during this time required a GSEC employee in the Operations department to update the information contained in two spreadsheets – one spreadsheet contained information for T+4 obligations due that morning, while the other contained T+6 obligations. However, on this date, the employee failed to update the T+6 spreadsheet correctly. As a result, information sent to the Client Services department was a day

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<sup>10</sup> Rule 204T(e) exempted broker-dealers from the pre-borrow penalty if the firm had made a *bona fide* purchase of securities on or after the date of the trade but no later than the end of regular trading hours on the settlement date for the transaction sufficient to cover that firm's entire open short position, and that the firm could demonstrate that it had a net long or net flat position on its books and records on that settlement day. This is known as the "pre-fail credit."

<sup>11</sup> Rule 204T(a)(2) extended the deadline for closing out fail to deliver positions resulting from sales pursuant to Rule 144 of the Securities Act of 1933 to the beginning of regular trading hours on the thirty-sixth day following the settlement date.

old. Client Services' calculations were therefore incorrect. As a consequence, GSEC bought shares for which it had no T+6 obligation, while at the same time it did not close out certain actual T+6 fail positions.

11. GSEC detected the mistake and bought in the correct amounts after market open on December 9. However, as a result of the error, GSEC and certain of its broker-dealer customers were subject to the pre-borrow penalty until these purchases settled on December 12, 2008. As a result, two NYSE Arca Lead Market Makers who were subject to this pre-borrow penalty were unable to continue to make markets in two securities.

#### **January 6, 2009 – January 22, 2009**

12. From January 6, 2009 through January 22, 2009 GSEC, on approximately 46 occasions, failed to timely close out T+6 positions in 38 securities. These failures resulted from GSEC's error in calculating its potential T+6 obligations. The procedure in place at GSEC during this time period required that after GSEC had bought securities on the morning of T+4, Client Services would send the final purchase information to Operations. Operations would then manually calculate the T+6 obligation. The spreadsheet that Operations received from Client Services contained the details of the T+4 purchase calculations, which included the shares that were exempted as the result of market making activities.

13. In early January 2009, while modifying the spreadsheet provided by Client Services, an employee in the Operations department removed the number of shares attributable to the market maker exemption from the spreadsheet. Because the data was a component of a mathematical formula, this resulted in an inaccurate increase to the number of shares reported as having been purchased on T+4. GSEC then used this incorrect number to calculate the T+6 close-out obligation. The T+6 calculations were therefore incorrectly low and, during this period, GSEC purchased inadequate numbers of shares on approximately 46 occasions.

14. The erroneous T+6 calculations were first made on January 6, 2009, and continued undetected by GSEC until January 22, 2009. The error was brought to GSEC's attention by a customer who advised GSEC of a potential problem concerning GSEC's calculation. Upon investigating this information, GSEC confirmed the error and notified regulators and its broker, dealer, and market maker customers.

15. During the time the error remained undetected, GSEC and its broker-dealer customers were subject to the pre-borrow penalty for the 38 affected securities, but accepted approximately 385 short sales in those securities without a pre-borrow. Upon discovery of the error, one NYSE Designated Market Maker ("DMM") was subject to the pre-borrow penalty, meaning that trading in one of that market maker's assigned stocks was halted and the stock was reallocated by the NYSE to another DMM firm.

### Violations

16. As a result of the conduct described above, GSEC willfully<sup>12</sup> violated Rule 204T of Regulation SHO by failing to deliver certain securities or immediately purchase or borrow securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the required date.

### GSEC's Remedial Efforts

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

### Undertaking

18. Pursuant to the New York Stock Exchange LLC Hearing Board decision accepting Stipulation of Facts and Consent to Penalty entered into by Respondent GSEC and NYSE Regulation on May 3, 2010, Respondent GSEC agreed to pay a fine in the amount of \$225,000 to NYSE Regulation.

In determining whether to accept the Offer, the Commission has considered this undertaking.

## 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.

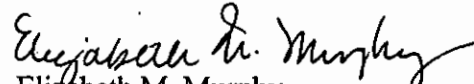
Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

- A. Respondent GSEC cease and desist from committing or causing any violations and any future violations of Exchange Act Rule 204;
- B. Respondent GSEC is censured; and
- C. Respondent shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$225,000 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 wire transfer, 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

<sup>12</sup> 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)).

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 Goldman Sachs Execution & Clearing, L.P. as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Elaine C. Greenberg, Associate Regional Director, Philadelphia Regional Office, Securities and Exchange Commission, 701 Market Street, Suite 2000, Philadelphia, PA 19106.

By the Commission.

  
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. 62030 / May 4, 2010

ADMINISTRATIVE PROCEEDING  
File No. 3-13878

In the Matter of

John L. Milling,  
  
Respondent.

ORDER INSTITUTING PUBLIC  
ADMINISTRATIVE PROCEEDINGS AND  
IMPOSING TEMPORARY SUSPENSION  
PURSUANT TO RULE 102(e)(3) OF THE  
COMMISSION'S RULES OF PRACTICE

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Rule 102(e)(3)<sup>1</sup> of the Commission's Rules of Practice against John L. Milling ("Milling").

II.

The Commission finds that:

A. RESPONDENT

1. John L. Milling, age 76, is and has been an attorney licensed to practice in New York and New Jersey. From 2000 through July 2003, Milling was the President, Chief Executive Officer, General Counsel and a Director of Tecumseh Holdings Corporation.

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<sup>1</sup> Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . attorney . . . 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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B. CIVIL INJUNCTION

2. On March 1, 2010, the U.S. District Court for the Southern District of New York entered an amended judgment against Milling, permanently enjoining him from future violations, direct or indirect, of Section 5 of the Securities Act of 1933. Securities and Exchange Commission v. Tecumseh Holdings Corp., et al., Civil Action Number 03-Civ-5490.

3. The Commission's complaint alleged, among other things, that Milling and others engaged in the unregistered offer and sale of securities of Tecumseh and Tecumseh's subsidiary, Tecumseh Tradevest LLC ("Tradevest") from June 2000 to July 2003. Through the unregistered offerings, Milling and others raised at least \$10 million from about 500 investors nationwide. No registration statement was in effect as to any of the securities being offered and sold. In addition, Milling wrote or directed the writing of all of Tecumseh's and Tradevest's offering memoranda.

**III.**

Based upon the foregoing, the Commission finds that a court of competent jurisdiction has permanently enjoined Milling, an attorney, from violating the Federal securities laws within the meaning of Rule 102(e)(3)(i)(A) of the Commission's Rules of Practice. In view of these findings, the Commission deems it appropriate and in the public interest that Milling be temporarily suspended from appearing or practicing before the Commission.

IT IS HEREBY ORDERED that Milling be, and hereby is, temporarily suspended from appearing or practicing before the Commission. This Order shall be effective upon service on Milling.

IT IS FURTHER ORDERED that Milling may within thirty days after service of this Order file a petition with the Commission to lift the temporary suspension. If the Commission within thirty days after service of the Order receives no petition, the suspension shall become permanent pursuant to Rule 102(e)(3)(ii).

If a petition is received within thirty days after service of this Order, the Commission shall, within thirty days after the filing of the petition, either lift the temporary suspension, or set the matter down for hearing at a time and place to be designated by the Commission, or both. If a hearing is ordered, following the hearing, the Commission may lift the suspension, censure the petitioner, or disqualify the petitioner from appearing or practicing before the Commission for a period of time, or permanently, pursuant to Rule 102(e)(3)(iii).

This Order shall be served upon Milling personally or by certified mail at his last known address.

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. 62047 / May 6, 2010

**ADMINISTRATIVE PROCEEDING**  
File No. 3-13882

In the Matter of	:	ORDER INSTITUTING
	:	ADMINISTRATIVE
American Healthchoice, Inc.,	:	PROCEEDINGS AND NOTICE
American Patriot Funding, Inc.	:	OF HEARING PURSUANT TO
(f/k/a Referral Holdings Corp.),	:	SECTION 12(j) OF THE
American Quantum Cycles, Inc.,	:	SECURITIES EXCHANGE ACT
Americare Health Scan, Inc.	:	OF 1934
(f/k/a United Products	:	
International, Inc.), and	:	
Annex, Inc.,	:	
	:	
Respondents.	:	

**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 Healthchoice, Inc., American Patriot Funding, Inc. (f/k/a Referral Holdings Corp.), American Quantum Cycles, Inc., Americare Health Scan, Inc. (f/k/a United Products International, Inc.), and Annex, Inc.

**II.**

After an investigation, the Division of Enforcement alleges that:

**A. RESPONDENTS**

1. American HealthChoice, Inc. (CIK No. 854862) is a New York corporation located in Flower Mound, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American HealthChoice is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2006, which reported a net loss of \$117,947 for the prior three months. As of April 30, 2010, the company's stock (symbol "AMHI") was quoted on the Pink Sheets, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. American Patriot Funding, Inc. (f/k/a Referral Holdings Corp.) (CIK No. 1131338) is a Nevada corporation located in Orlando, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Patriot is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2001, which reported a net loss of \$70,271 for the prior three months. As of April 30, 2010, the company's stock (symbol "APAT") 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).

3. American Quantum Cycles, Inc. (CIK No. 1041970) is a dissolved Florida corporation located in Melbourne, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Quantum 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 July 31, 2000, which reported a net loss of over \$3 million for the prior three months. As of April 30, 2010, the company's stock (symbol "AQCY") 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).

4. Americare Health Scan, Inc. (f/k/a United Products International, Inc.) (CIK No. 1030144) is a Florida corporation located in Miami, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Health is delinquent in its periodic filings with the Commission, having not filed any periodic reports during the following periods: since the period ended September 30, 2008; from the period ended March 31, 2004 through the period ended December 31, 2005; and from the period ended December 31, 1997 through the period ended June 30, 2001. The company's last filing, a Form 10-Q for the period ended September 30, 2008, reported a net loss of over \$2.75 million since January 1, 2005. As of April 30, 2010, the company's stock (symbol "AMIT") 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).

5. Amnex, Inc. (CIK No. 793526) is an inactive New York corporation located in Lake Success, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Amnex is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 1999, which reported a net loss of over \$6.34 million for the prior three months. As of April 30, 2010, the company's stock (symbol "AMXIQ") 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).

## B. DELINQUENT PERIODIC FILINGS

6. 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.

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

8. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

### III.

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

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

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any 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 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

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

May 6, 2010

IN THE MATTER OF

Alyn Corp.,  
American HealthChoice, Inc.,  
American Holding Investments, Inc.,  
American Midland Corp.,  
American Millennium Corp.,  
American Pallet Leasing, Inc.,  
American Patriot Funding, Inc.  
(f/k/a Referral Holdings Corp.),  
American Quantum Cycles, Inc.,  
American Stellar Energy, Inc.  
(n/k/a Tara Gold Resources Corp.),  
Americare Health Scan, Inc.  
(f/k/a United Products  
International, Inc.),  
Amnex, Inc., and  
Amwest Environmental Group, Inc.,

ORDER OF SUSPENSION  
OF TRADING

File No. 500-1

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Alyn Corp. because it has not filed any periodic reports since the period ended March 31, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of American HealthChoice, Inc. because it has not filed any periodic reports since the period ended June 30, 2006.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of American Holding

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Investments, Inc. because it has not filed any periodic reports since the period ended December 31, 2004.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of American Midland Corp. because it has not filed any periodic reports since the period ended December 31, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of American Millennium Corp. because it has not filed any periodic reports since the period ended April 30, 2003.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of American Pallet Leasing, Inc. because it has not filed any periodic reports since the period ended March 31, 2006.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of American Patriot Funding, Inc. (f/k/a Referral Holdings Corp.) because it has not filed any periodic reports since the period ended June 30, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of American Quantum Cycles, Inc. because it has not filed any periodic reports since the period ended July 31, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of American Stellar Energy, Inc. (n/k/a Tara Gold Resources Corp.) because it has not filed any periodic reports since September 30, 2007.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Americare Health Scan, Inc. (f/k/a United Products International, Inc.) because it has not filed any periodic reports during the following periods: since the period ended September 30, 2008; from the period ended March 31, 2004 through the period ended December 31, 2005; and from the period ended December 31, 1997 through the period ended June 30, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Amnex, Inc. because it has not filed any periodic reports since March 31, 1999.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Amwest Environmental Group, Inc. because it has not filed any periodic reports since May 31, 1997.

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. EDT on May 6, 2010, through 11:59 p.m. EDT on May 19, 2010.

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. 62046 / May 6, 2010

ADMINISTRATIVE PROCEEDING  
File No. 3-13881

In the Matter of

Alyn Corp.,  
American Holding Investments, Inc.,  
American Midland Corp.,  
American Millennium Corp.,  
American Pallet Leasing, Inc.,  
American Stellar Energy, Inc.  
(n/k/a Tara Gold Resources  
Corp.), and  
Amwest Environmental Group, 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 Alyn Corp., American Holding Investments, Inc., American Midland Corp., American Millennium Corp., American Pallet Leasing, Inc., American Stellar Energy, Inc. (n/k/a Tara Gold Resources Corp.), and Amwest Environmental Group, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Alyn Corp. (CIK No. 1015298) is a void Delaware corporation located in Irvine, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Alyn is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q/A for the period ended March 31, 2000, which reported a net loss of over \$1.79 million for the prior three months. On July 31, 2000, the company filed a Chapter 7 petition in the U.S.

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Bankruptcy Court for the Central District of California, which was still pending as of April 30, 2010. As of April 30, 2010, the company's stock (symbol "ALYNQ") was quoted on the Pink Sheets operated by Pink OTC Markets, Inc. ("Pink Sheets"), had three market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. American Holding Investments, Inc. (CIK No. 1108467) is a Nevada corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Holding 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, 2004, which reported a net loss of \$759,965 for the prior twelve months. As of April 30, 2010, the company's stock (symbol "AHDI") was quoted on the Pink Sheets, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. American Midland Corp. (CIK No. 66052) is a New York corporation located in Puntarenas, Costa Rica with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Midland is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 2000. As of April 30, 2010, the company's stock (symbol "AMCO") 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).

4. American Millennium Corp. (CIK No. 350193) is a Delaware corporation located in Golden, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Millennium 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 April 30, 2003, which reported a net loss of \$420,154 for the prior three months. As of April 30, 2010, the company's stock (symbol "AMCI") was quoted on the Pink Sheets, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. American Pallet Leasing, Inc. (CIK No. 1106641) is a void Delaware corporation located in Glenview, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Pallet 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, 2006, which reported a net loss of \$156,338 for the prior nine months. As of April 30, 2010, the company's stock (symbol "APLS") was quoted on the Pink Sheets, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

6. American Stellar Energy, Inc. (n/k/a Tara Gold Resources Corp.) (CIK No. 1100747) is a Nevada corporation located in Wheaton, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Stellar 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, 2007, which reported a net loss of \$1.7 million for the prior three months. As of April 30, 2010, the company's stock (symbol "TRGD") was quoted on the Pink Sheets, had fifteen

market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

7. Amwest Environmental Group, Inc. (CIK No. 941813) is a Nevada corporation located in Los Alamitos, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Amwest 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 May 31, 1997, which reported a net loss of \$288,829 for the prior three months. As of April 30, 2010, the company's stock (symbol "AEGI") 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

8. 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.

9. 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.

10. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

### III.

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

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

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any 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 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

By:   
Jill M. Peterson  
Assistant Secretary

Chairman Schapiro  
Commissioner Paredes  
not participating

UNITED STATES OF AMERICA  
before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Rel. No. 62055 / May 6, 2010

Admin. Proc. File No. 3-13810

In the Matter of the Application of

GREGORY S. PROFETA

25215 North Carmel Hills Drive  
Carmel, CA 93923

For Review of Disciplinary Action Taken by the  
Financial Industry Regulatory Authority, Inc.

ORDER GRANTING  
MOTION TO DISMISS  
APPLICATION FOR  
REVIEW

I.

On March 8, 2010, Gregory S. Profeta ("Applicant") filed an application for review of disciplinary action taken by the Financial Industry Regulatory Authority, Inc. ("FINRA") on February 8, 2010 barring Applicant from associating with any FINRA member in any capacity. On March 22, 2010, FINRA filed a "Motion to Dismiss Profeta's Application for Review and to Stay Briefing Schedule" in which FINRA asked us to, among other things, dismiss Applicant's appeal because Applicant failed to avail himself of FINRA's procedures to contest the bar.<sup>1</sup> Applicant did not file a response to FINRA's motion.

For the reasons set forth below, we have determined to grant FINRA's motion to dismiss Applicant's application.

<sup>1</sup> FINRA also asked us to extend the briefing schedule in this matter until we ruled on FINRA's motion to dismiss, which we did on March 26, 2010. *Gregory S. Profeta*, Admin. Proc. File No. 3-13810, Order (Mar. 26, 2010).

## II.

On October 28, 2008, M.L. Stern & Co., LLC ("M.L. Stern"), a former FINRA member firm, filed a Uniform Application for Securities Industry Registration (the "Form U4") with FINRA on behalf of Applicant, and the Form U4 was amended on December 23, 2008.<sup>2</sup> The Form U4 asked Applicant to, among other things, disclose whether Applicant had been charged with a misdemeanor involving the wrongful taking of property or a felony. Applicant did not disclose anything on the Form U4 in response to these questions.

FINRA conducted a background search on Applicant and discovered three criminal matters that Applicant may have been required to disclose on the Form U4. On April 16, 2009, FINRA sent Applicant a letter (the "First Letter") pursuant to FINRA Rule 8210<sup>3</sup> requesting certain information regarding these criminal matters, including related charging documents, documents evidencing sentencing or disposition, and why such matters were not disclosed by Applicant on the Form U4. The First Letter asked for Applicant's response by April 30, 2009. FINRA sent the First Letter to Applicant's address of record in the Central Registration Depository (the "CRD"). Applicant does not contest receipt of the First Letter and did not respond to it.

On May 1, 2009, FINRA sent Applicant a second letter (the "Second Letter") pursuant to FINRA Rule 8210 requesting the same information that it had requested in the First Letter. The Second Letter asked for Applicant's response by May 14, 2009, and was also sent to Applicant's CRD address. The Second Letter was returned to FINRA marked "unclaimed" on May 19, 2009.

FINRA sent Applicant a third letter on August 5, 2009 (the "Third Letter") notifying Applicant that, pursuant to FINRA Rule 9552(a),<sup>4</sup> he would be suspended on August 31, 2009 if he did not provide FINRA with the information requested in the First and Second Letters. The Third Letter further notified Applicant of his right to request a hearing in connection with this matter prior to August 31, 2009 pursuant to FINRA Rule 9552(e). Applicant does not contest receipt of the Third Letter and did not respond to it.

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<sup>2</sup> The record does not indicate what changes were made in the amended Form U4. M.L. Stern terminated Applicant on January 14, 2009 for failure to pass the General Securities Representative Examination.

<sup>3</sup> FINRA Rule 8210 requires individuals associated with a FINRA member firm to provide information upon request with respect to any matter involved in an investigation.

<sup>4</sup> FINRA Rule 9552(a) permits FINRA to suspend the association of an individual with a FINRA member firm upon twenty-one days' notice if such individual does not provide FINRA with information requested pursuant to FINRA's rules.



On August 31, 2009, FINRA sent Applicant a fourth letter (the "Fourth Letter") notifying him of his suspension effective that date and notifying him that he would be barred from associating with a FINRA member in any capacity on February 8, 2010 pursuant to FINRA Rule 9552(h) if he did not provide FINRA with the requested information and request termination of his suspension pursuant to FINRA Rule 9552(f). FINRA sent the Fourth Letter to Applicant's CRD address and to five other addresses associated with Applicant that FINRA had obtained through a search of public records. Applicant does not contest receipt of the Fourth Letter and did not respond to it.

On February 8, 2010, FINRA sent Applicant a fifth letter (the "Fifth Letter") notifying him that he was barred from associating with a FINRA member firm in any capacity effective that date. The Fifth Letter also notified Applicant of his right to appeal the disciplinary sanction to the Commission within thirty days. Applicant timely filed this application for review.

### III.

We have previously held that we will not consider an application for review if the applicant failed to exhaust FINRA's procedures for contesting the sanction at issue.<sup>5</sup> We have also previously stated that "[i]t is clearly proper to require that a statutory right to review be exercised in an orderly fashion, and to specify procedural steps which must be observed as a condition to securing review."<sup>6</sup>

Here, FINRA's actions were in accordance with its rules and the purposes of the Exchange Act. FINRA's rules set forth the procedures for suspending and ultimately barring individuals who fail to supply requested information or take corrective action. Pursuant to these rules, FINRA informed Applicant in its various letters to him that he would be suspended and automatically barred if he failed to respond to FINRA's inquiry or request a hearing to contest his impending sanction. Applicant chose not to avail himself of these procedures. He failed to respond to FINRA's requests for information or request a hearing to contest his impending sanction. As a result, Applicant's bar was imposed automatically in accordance with FINRA's rules.

Applicant does not dispute the basis for FINRA's action – that he had notice of FINRA's requests and failed to respond to FINRA's letters or request a hearing to contest his impending

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<sup>5</sup> See, e.g., *Jeffrey A. King*, Securities Exchange Act Rel. No. 52571 (Oct. 7, 2005), 86 SEC Docket 1439 (dismissing application for review for failure by applicant to pursue NASD administrative procedures under predecessor to FINRA Rule 9552); *Lee Gura*, 57 S.E.C. 972 (2004) (same); *Gary A. Fox*, 55 S.E.C. 1147 (2002) (same); see also *Edward J. Jakubik, Jr.*, Exchange Act Rel. No. 61541 (Feb. 18, 2010), \_\_ SEC Docket \_\_, \_\_.

<sup>6</sup> *Royal Sec. Corp.*, 36 S.E.C. 275, 277 (1955), cited with approval in *David I. Cassuto*, 56 S.E.C. 565, 571 (2003) and *Fox*, 55 S.E.C. at 1149-50.

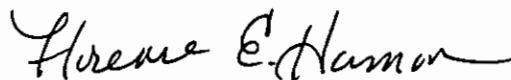
sanction. Instead, Applicant argues that, with respect to one of the criminal matters discovered by FINRA, "I was not charged with anything" and "my lawyer . . . said that I do not have to answer yes to the question as I was not sentenced and in fact the records, because I was under 18 years old, were expunged from my records." Regarding the other two criminal matters discovered by FINRA, Applicant argues that "I did not state anything about these incidents because they are not accurate. I have no recollection of any conviction of [the matters identified by FINRA]. In fact it is insulting to me that somehow these accusations about me are being stated. This is in fact part of the reason that I have waited to respond. When I first saw this it really offended me and I did not want to even dignify the letter with a response."

Applicant's reasons for not responding to FINRA's letters do not mitigate his failure to comply with FINRA's procedures. Applicant chose not to respond to FINRA's letters to raise these issues or request a hearing to challenge his impending sanction, and therefore cannot complain at this stage about the consequence of his choice.<sup>7</sup>

Accordingly, it is ORDERED that FINRA's motion to dismiss the application for review filed by Gregory Profeta be, and it hereby is, GRANTED.

By the Commission.

Elizabeth M. Murphy  
Secretary



By: Florence E. Harmon  
Deputy Secretary

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<sup>7</sup> We have considered all of the parties' contentions. We have rejected or sustained them to the extent they are inconsistent or in accord with the views expressed herein.

*Commissioner Aquilar  
not participating*

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

May 10, 2010

In the Matter of

UNIVERSAL PROPERTY  
DEVELOPMENT &  
ACQUISITION 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 Universal Property Development & Acquisition Corp. ("Universal Property") because it has not filed any periodic reports since the period ended March 31, 2008. Universal Property is quoted on the Pink Sheets operated by Pink OTC Markets, Inc. under the ticker symbol UPDV.

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

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EDT on May 10, 2010, through 11:59 p.m. EDT on May 21, 2010.

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. 62063 / May 10, 2010

ADMINISTRATIVE PROCEEDING

File No. 3-13883

In the Matter of

UNIVERSAL PROPERTY  
DEVELOPMENT &  
ACQUISITION CORP.,

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 Universal Property Development & Acquisition Corp. ("Universal Property" or "Respondent").

II.

After an investigation, the Division of Enforcement alleges that:

A. Universal Property is a Nevada corporation with its principal offices in Juno Beach, Florida. Universal Property purports to be an oil and gas company and its common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act. Universal Property's common stock is quoted on the Pink Sheets operated by Pink OTC Markets Inc.

B. Universal Property has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, while its common stock was registered with the Commission in that it has not filed an Annual Report on Form 10-K since April 15, 2008 (for its year ending December 31, 2007) or quarterly reports on Form 10-Q for any fiscal period subsequent to its fiscal quarter ending March 31, 2008.

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### 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 proceedings be instituted pursuant to Section 12(j) of the Exchange Act to determine:

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

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding 12 months or revoke the registration of each class of securities of Universal Property 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 FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

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

This Order shall be served upon Respondent in accordance with Rule 141 of the Commission's Rules of Practice, 17 C.F.R. § 201.141.

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.

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 on 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**

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 62065 / May 10, 2010**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-11659**

**In the Matter of**

**Bridgeway Capital Management, Inc. and  
John Noland Ryan Montgomery,**

**Respondents.**

**ORDER DISCHARGING PLAN  
ADMINISTRATOR AND  
TERMINATING DISGORGEMENT  
FUND**

On February 10, 2005, the Commission published a notice of the Plan of Distribution ("Plan") proposed by the Division of Enforcement in connection with this proceeding (Advisers Act Release No. 2358). The Plan of Distribution proposed that a Disgorgement Fund, consisting of \$4,407,700 in disgorgement and \$485,714 in prejudgment interest, be distributed to eligible shareholders based upon a determination of the amount of overcharges plus prejudgment interest incurred while the eligible shareholder held a share in the affected mutual fund. Prejudgment interest was credited to shareholders, on a pro-rata basis, for the period July 1995 through March 22, 2004.

On March 16, 2005, the Commission issued an order approving the Plan of Distribution and appointing Stephen Webster, Esq., as Plan Administrator (Advisers Act Release No. 2367). From June 2007 through May 2008, the distribution of \$4,231,024 was made to approximately 42,700 separate accounts.

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 on May 4, 2010. Pursuant to the Plan Administrator's Final Accounting all tax liabilities have been satisfied and the \$628,165.57 remaining in the Disgorgement Fund was transmitted to the U.S. Treasury.

Accordingly, IT IS ORDERED the Disgorgement Fund is terminated.

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IT IS FURTHER ORDERED THAT the Plan Administrator is discharged.

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. 62068 / May 10, 2010**

**INVESTMENT ADVISERS ACT OF 1940  
Release No. 3023 / May 10, 2010**

**ADMINISTRATIVE PROCEEDING  
File No. 3-13884**

**In the Matter of**  
  
**SUSAN G. SLOVAK,**  
  
**Respondent.**

**ORDER INSTITUTING  
ADMINISTRATIVE PROCEEDINGS PURSUANT  
TO SECTION 15(b) OF THE SECURITIES  
EXCHANGE ACT OF 1934 AND SECTION 203(f)  
OF THE INVESTMENT ADVISERS ACT OF 1940,  
MAKING FINDINGS, AND IMPOSING  
REMEDIAL SANCTIONS**

**I.**

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Susan G. Slovak ("Respondent").

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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### III.

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

1. Slovak, age 51, is a resident of Ennis, Texas. From at least 2005 until January 6, 2009, Slovak was a registered representative associated with broker-dealers and investment advisers registered with the Commission.
2. On April 30, 2010, a final judgment was entered by consent against Slovak, permanently enjoining her from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and (2) of the Advisers Act, in the civil action entitled Securities and Exchange Commission v. Susan G. Slovak, Civil Action Number 3:10-CV-826-N, in the United States District Court for the Northern District of Texas.
3. The Commission's complaint alleged that, while serving as a registered representative associated with broker-dealers and investment advisers registered with the Commission, Slovak misappropriated and misused more than \$144,000 from three customers' accounts. Moreover, the complaint alleged that, in order to accomplish and then cover up the scheme, Slovak made material misstatements and omissions in her communications with affected customers and compliance personnel.

### IV.

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

Accordingly, it is hereby ORDERED:

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

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization

arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

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 EXCHANGE ACT OF 1934**  
**Release No. 62072 / May 11, 2010**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-13885**

<p><b>In the Matter of</b></p> <p><b>LEONARD J. ADAMS,</b></p> <p><b>Respondent.</b></p>	<p><b>ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER</b></p>
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**I.**

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Leonard J. Adams ("Adams" 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 Respondent 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 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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### III.

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

#### Summary

1. These proceedings arise out of numerous violations of Rule 105 of Regulation M, a rule designed to protect the independent pricing mechanism of the securities market shortly before follow-on and secondary offerings, by Leonard J. Adams.<sup>1</sup> Adams violated Rule 105 in connection with offerings from at least March 2006 through December 2008 (the "relevant period"). Adams engaged in a strategy of participating in numerous secondary offerings of stock in public companies in order to improve his access to initial public offerings underwritten by the same broker-dealers through which he participated in the secondary offerings. At all relevant times through October 9, 2007, Rule 105 prohibited covering a short sale with securities obtained in a public offering when the short sale occurred during a restricted period, generally five business days before the pricing of the offering. Since October 9, 2007, Rule 105 prohibits any person effecting a short sale during the restricted period from purchasing shares offered in a secondary offering. Adams violated Rule 105 in connection with at least 94 offerings between March 2006 and December 2008, resulting in gains of \$331,387.

#### Respondent

2. **Leonard J. Adams**, age, 61, is a resident of Boca Raton, Florida. Adams is retired from a family-owned fabric manufacturing business and has been a full-time investor since 1993.

#### Background

##### **Rule 105**

3. Prior to October 2007, Rule 105 of Regulation M, "Short Selling in Connection with a Public Offering," provided, in pertinent part:

In connection with an offering of securities for cash pursuant to a registration statement ... filed under the Securities Act, it shall be unlawful for any person to cover a short sale with offered securities purchased from an underwriter or broker or dealer participating in the offering, if such a short sale occurred during the ... period beginning five business days before the pricing of the offered securities and ending with such pricing ...

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<sup>1</sup> "The first time an issuer conducts a public offering of its securities, the offering is referred to as an initial public offering ("IPO"). Subsequent offerings by the issuer are referred to as follow-on offerings or repeat offerings. A secondary offering is an offering of securities held by security holders, for which there already exist trading markets for the same class of securities as those being offered." Short Selling in Connection With a Public Offering: Proposed Rule, 71 Fed. Reg. 75002, 75003 n.12 (Dec. 13, 2006) ("Proposing Release on Rule 105").

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, 23<sup>rd</sup> Floor, Boston, MA 02110.

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 EXCHANGE ACT OF 1934  
Release No. 62073 / May 11, 2010**

**ADMINISTRATIVE PROCEEDING  
File No. 3-13886**

<p><b>In the Matter of</b></p> <p><b>PETER G. GRABLER,</b></p> <p><b>Respondent.</b></p>	<p><b>ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER</b></p>
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**I.**

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Peter G. Grabler ("Grabler" 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 Respondent 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 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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### III.

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

#### Summary

1. These proceedings arise out of numerous violations of Rule 105 of Regulation M, a rule designed to protect the independent pricing mechanism of the securities market shortly before follow-on and secondary offerings, by Peter G. Grabler.<sup>1</sup> Grabler violated Rule 105 in connection with offerings from at least February 2006 through November 2008 (the "relevant period"). Grabler engaged in a strategy of participating in numerous secondary offerings of stock in public companies in order to improve his access to initial public offerings ("IPOs") underwritten by the same broker-dealers through which he participated in the secondary offerings. At all relevant times through October 9, 2007, Rule 105 prohibited covering a short sale with securities obtained in a public offering when the short sale occurred during a restricted period, generally five business days before the pricing of the offering. Since October 9, 2007, Rule 105 prohibits any person effecting a short sale during the restricted period from purchasing shares offered in a secondary offering. Grabler violated Rule 105 in connection with at least 119 offerings between February 2006 and November 2008, resulting in gains of \$636,123.

#### Respondent

2. **Peter G. Grabler**, age 55, is a resident of Boca Raton, Florida. Grabler is a licensed attorney in Massachusetts and Florida, but he has not engaged in the practice of law since the 1980's. Grabler is retired and has been a full-time investor since the 1990's.

#### Background

##### **Rule 105**

3. Prior to October 2007, Rule 105 of Regulation M, "Short Selling in Connection with a Public Offering," provided, in pertinent part:

In connection with an offering of securities for cash pursuant to a registration statement ... filed under the Securities Act, it shall be unlawful for any person to cover a short sale with offered securities purchased from an underwriter or broker or dealer participating in the offering, if such a short sale occurred during the ... period beginning five business days before the pricing of the offered securities and ending with such pricing ...

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<sup>1</sup> "The first time an issuer conducts a public offering of its securities, the offering is referred to as an initial public offering ("IPO"). Subsequent offerings by the issuer are referred to as follow-on offerings or repeat offerings. A secondary offering is an offering of securities held by security holders, for which there already exist trading markets for the same class of securities as those being offered." Short Selling in Connection With a Public Offering: Proposed Rule, 71 Fed. Reg. 75002, 75003 n.12 (Dec. 13, 2006) ("Proposing Release on Rule 105").



17 C.F.R. § 242.105(a)(1).

4. The Commission amended Rule 105 effective October 9, 2007, to provide, in pertinent part:

In connection with an offering of equity securities for cash pursuant to a registration statement ... filed under the Securities Act of 1933 ("offered securities"), it shall be unlawful for any person to sell short ... the security that is the subject of the offering and purchase the offered securities from an underwriter or broker or dealer participating in the offering if such short sale was effected during the period ("Rule 105 restricted period") that is the shorter of the period:

(1) Beginning five business days before the pricing of the offered securities and ending with such pricing; or (2) Beginning with the initial filing of such registration statement ... and ending with the pricing.

17 C.F.R. § 242.105(a)(1) (effective October 9, 2007).

5. The Commission amended Rule 105 to eliminate the covering component to "reduce[] a potential investor's incentive to aggressively sell short prior to pricing solely due to the anticipation of this discount." *Id.* Both the pre- and post-amendment versions of Rule 105 are prophylactic and prohibit the conduct irrespective of the short seller's intent in effecting the short sale. *See id.* at 45094 ("Rule 105 is prophylactic. Thus, its provisions apply irrespective of a seller's intent"); Proposing Release on Rule 105, 71 Fed. Reg. at 75002 ("The proposal, like the current rule, provides a bright line test for Rule 105 compliance consistent with the prophylactic nature of Regulation M").

### **Grabler's Trading**

6. During the relevant period, Grabler participated in secondary offerings in order to improve his access to IPOs. Grabler opened or controlled at least 52 brokerage accounts at more than a dozen broker-dealers. These accounts gave Grabler potential access to IPOs underwritten by those broker-dealers. With respect to customers such as Grabler, these broker-dealers generally allocated IPOs based upon the amount of commissions and sales credits those customers generated. Because the commissions and sales credits generated by purchases of shares in secondary offerings were substantially greater than commissions generated by open market transactions, Grabler agreed to participate in numerous secondary offerings. And to hedge those transactions, he frequently sold short the stock of the issuing companies.

7. From at least February 2006 through November 2008, Grabler engaged in transactions prohibited by Rule 105 on at least 119 occasions involving secondary offerings by at least 102 issuers. These violations include at least 60 violations prior to October 9, 2007 ("pre-amendment violations") and at least 59 violations after that date ("post-amendment violations").

8. Grabler's pre-amendment violations involve two types of transactions: (1) direct covering of short positions with offering shares, either within the same account or through transfers of offering shares from one account to another; and (2) transactions in which, rather than directly covering a short position with offering shares, Grabler placed orders before the market opened to both buy shares in the market in one or more accounts and sell offering shares in one or more different accounts in what amounted to riskless transactions.

9. For example, on June 7, 2006, Grabler sold short 60,000 shares of Level 3 Communications, Inc. ("Level 3"), stock in one account within five days of the date the company priced its secondary offering (after the market closed on June 7, 2006) at a price of \$34.57 per share. Grabler then purchased 94,000 shares of Level 3 stock in the secondary offering through 11 different accounts at the offering price of \$32.75. He then transferred 60,000 offering shares to cover the short position.

10. As an example of what amounted to Grabler's riskless transactions, from November 30, 2006 through December 4, 2006, he sold short 24,000 shares of Odyssey Re Holdings Corp. ("Odyssey") stock within five days of the date the company priced its secondary offering (after the market closed on December 4, 2006) at a volume weighted average price of \$35.51 per share. Grabler then purchased 15,000 shares in the secondary offering at a price of \$34.60. On December 5, 2006, before the market opened, Grabler placed orders to purchase 13,000 shares of Odyssey stock in the market with one broker-dealer and to sell the 9,000 of the shares of Odyssey stock purchased in the secondary offering with another broker-dealer. Those transactions were executed within 45 seconds of each other at the same price of \$34.25.

11. An example of Grabler's post-amendment violations is his trading in the shares of American International Group, Inc. ("AIG") in May 2008. From May 9, 2008 through May 12, 2008, Grabler sold short 35,000 shares of AIG stock in three accounts at a weighted average price of \$38.99 per share. On May 12, 2008, after the markets closed, AIG priced its secondary offering. On May 13, 2008, Grabler purchased 71,400 AIG shares in four accounts at the offering price of \$38.00 per share in connection with that secondary offering. Grabler's short sales of AIG stock were within 5 days of the pricing of the offering and thus fell within the restricted period under Rule 105. As a result, Grabler violated Rule 105 when he purchased the AIG offering shares after having sold AIG stock short during the restricted period.

## **Violations**

12. As a result of the conduct described above, from at least February 2006 through October 9, 2007, Grabler violated Rule 105 of Regulation M, which at the time made it "unlawful for any person to cover a short sale with offered securities purchased from an underwriter or broker or dealer participating in an offering, if such short sales occurred during the ... period beginning five business days before pricing of the offered securities and ending with such pricing."

13. As a result of the conduct described above, from October 9, 2007 through November 2008, Grabler violated Rule 105 of Regulation M of the Exchange Act, as amended effective October 9, 2007, which makes it "unlawful for any person to sell short ... the security that is the subject of the offering and purchase the offered securities from an underwriter, broker or dealer participating in the offering if such short sale was effected during the period: (1) Beginning five business days before the pricing of the offered securities and ending with such pricing; or (2) Beginning with the initial filing of such registration statement ... and ending with such pricing."

#### IV.

In view of the foregoing, the Commission deems it appropriate to impose the cease-and-desist order agreed to in Respondent's Offer.

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

- A. Respondent shall cease and desist from committing or causing any violations and any future violations of Rule 105 of Regulation M of the Exchange Act.
- B. Respondent shall, within 30 days of the entry of this Order, pay disgorgement of \$636,123 and prejudgment interest in the amount of \$35,232 to the United States Treasury. If timely payment is not made, additional 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, Alexandria, VA 22312-0003; and (D) submitted under cover letter that identifies Peter G. Grabler 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, 23<sup>rd</sup> Floor, Boston, MA 02110.

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. 62075 / May 11, 2010**

**Administrative Proceeding**  
**File No. 3-12341**

**In the Matter of**

**WEISS RESEARCH, INC.,**  
**MARTIN WEISS, AND**  
**LAWRENCE EDELSON**

**Respondents.**

**ORDER APPROVING**  
**APPLICATION OF DISTRIBUTION**  
**ADMINISTRATOR FOR**  
**FEES AND EXPENSES AND**  
**DIRECTING DISBURSEMENT**  
**OF FAIR FUND**

On June 22, 2006, the Commission instituted settled administrative proceedings against Weiss Research, Inc., Martin Weiss, and Lawrence Edelson (collectively, "Respondents") for violations of the Investment Advisers Act of 1940 in connection with their operation of an unregistered investment adviser and the production and distribution of materially false and misleading marketing materials. See Order Instituting Public 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, Admin. Proc. File No. 3-12341 (Investment Advisers Act Rel. No. 2525) (June 22, 2006) ("Order"). Among other things, the Commission ordered the Respondents to pay a total of \$2,166,142 in disgorgement, prejudgment interest, and penalties, and authorized the creation of a Fair Fund to distribute this money to the harmed investors.

On July 5, 2007, the Commission published a notice of the Distribution Plan ("Plan") proposed by the Division of Enforcement in connection with this proceeding (Securities Exchange Act Rel. No. 56011). No comments were received. On August 23, 2007, the Commission approved the Plan. Order Approving Distribution Plan, Admin. Proc. File No. 3-12341 (Securities Exchange Act Rel. No. 56310). On April 22, 2009, the Commission issued an order authorizing the distribution of \$1,462,208 to harmed investors in accordance with the Plan. Order Directing Disbursement of Fair Fund, Admin Proc. File No. 3-12341 (Securities Exchange Act Re. No. 59813).

The Administrator has submitted detailed invoices for his fees and expenses incurred during the quarters ended September 30, 2009, December 31, 2009, and March 31, 2010. The Commission staff, having reviewed the invoices, finds the total fees and expenses of \$13,013.50 to be reasonable and in accordance with the Distribution Plan. The Commission staff has requested that the Commission authorize payment of the Administrator's fees and expenses in the amount of \$13,013.50 from the Fair Fund.

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The Administrator has also submitted a validated letter identifying one remaining payee with a claim for \$4,315.50. The Plan provides that the Commission will arrange for distribution of the Fair Fund when the Commission receives and accepts from the Administrator a validated list of payees with the identification information required to make the distribution. The Administrator's validated letter has been received and accepted.

Accordingly, IT IS HEREBY ORDERED, pursuant to Rule 1105(d) of the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F. R. § 201.1105(d), that the Administrator's current fees and expenses in the amount of \$13,013.50 be paid from the Fair Fund.

IT IS FURTHER ORDERED that the Administrator distribute \$4,315.50 to the payee in the validated letter, as provided for in the Plan.

By the Commission.

*Elizabeth M. Murphy*  
Elizabeth M. Murphy  
Secretary

*Commissioner Baredes  
not participating*

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933  
Release No. 9124 / May 11, 2010

SECURITIES EXCHANGE ACT OF 1934  
Release No. 62076 / May 11, 2010

INVESTMENT ADVISERS ACT OF 1940  
Release No. 3024 / May 11, 2010

INVESTMENT COMPANY ACT OF 1940  
Release No. 29266 / May 11, 2010

ADMINISTRATIVE PROCEEDING  
File No. 3-13887

In the Matter of

DAVID W. BALDT

Respondent.

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,  
SECTIONS 203(f) AND 203(k) OF THE  
INVESTMENT ADVISERS ACT OF 1940 AND  
SECTION 9(b) OF THE INVESTMENT  
COMPANY ACT OF 1940

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against David W. Baldt ("Respondent" or "Baldt").

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## II.

After an investigation, the Division of Enforcement alleges that:

### A. SUMMARY

1. These proceedings arise out of a municipal bond fund portfolio manager -- Baldt -- tipping his family members to redeem their shares in a fund he managed while Baldt possessed adverse material non-public information concerning the fund. From 2003 until October 14, 2008, Baldt served as portfolio manager for two municipal bond funds sponsored by Schroder Investment Management North America, Inc. ("Schroders"): Schroder Municipal Bond Fund ("Intermediate Fund") and Schroder Short-Term Municipal Bond Fund ("Short-Term Fund") (together, the "Funds"). Several members of Baldt's family invested the bulk of their life savings in the Short-Term Fund.

2. By mid-September 2008, market conditions were deteriorating and the Funds were experiencing increased redemption requests. On the afternoon of September 17, one of Baldt's family members ("Family Member A") called him for advice about what to do with her investment in the Short-Term Fund. He advised her that if her concerns about the investment were preventing her from sleeping at night, she should sell her investment and invest in U.S. Treasury bills. Baldt also told Family Member A that she should tell a second family member ("Family Member B") to do the same.

3. Subsequently, during the last two weeks of September and the first week of October, Schroders received increasing redemption requests for the Short-Term Fund as well as the Intermediate Fund. Schroders struggled to meet redemption requests, prompting Schroders' management to direct Baldt to sell enough bonds to maintain a cash cushion of 10-12 % in each of the two Funds, so that Schroders would have sufficient liquidity to meet redemption requests to both Funds in a timely manner.

4. Specifically, on September 29, Schroders management learned of a potential \$12 million Short-Term Fund redemption, which represented nearly 8% of that Fund's total assets. Regarding the potential redemption, a member of Baldt's team advised in an email (copying Baldt) that, "[w]e will face the same issues [that the Intermediate Fund has been facing] in terms of liquidity for the short fund." Management reiterated its directive to Baldt that his portfolio team needed to sell securities and raise cash in each of the two Funds so that all redemptions could be met in an orderly fashion. Management warned Baldt that if his team failed to raise the necessary cash, "the alternative may be to close the funds," by which they meant liquidate the funds in an orderly fashion.

5. On September 30, Baldt sent management an email responding to their directive to raise cash. He stated he had received their "mandate to liquidate fund assets at whatever the cost in order to meet redemptions and raise cash reserves" but believed this was an imprudent course of action. He argued that it would cause large unit price declines, which would lead to added redemptions, further sales, and "snowballing poor investment performance" -- which, in turn, would lead to a "rapid complete withdrawal of the remaining assets, forced liquidation into



vulture bids, and massive declines in the principal value of the shares.” He warned that this harm to the shareholders would be “far worse than freezing the funds’ assets and seeking to liquidate them in an orderly fashion.”

6. Notwithstanding Baldt’s denunciation of management’s directive, management reiterated its direction to raise a 10 to 12% cash cushion in each Fund. During the remainder of that week, Baldt’s portfolio team struggled to meet redemption requests and build the required cash cushion. Among other hurdles that week, on that Friday morning, a bond broker inquired whether Schroders was in trouble in light of the broker’s having identified that Schroders was bidding large portions of its portfolio, and that afternoon, the portfolio team learned of an additional redemption from the Short-Term Fund in excess of \$1 million and of another potential large redemption in an unknown amount.

7. During the late afternoon of October 3, 2008, Baldt spoke again with Family Member A. This time, he was the one to bring up the subject of her investment in the Short-Term Fund. He told her that she “really should consider [her] inclination to sell.” Family Member A confirmed she had already started selling subsequent to their September 17 conversation. Baldt emphasized that she should “go the full route.” He also told her to “tell [Family Member B] the same thing.” That same night, Family Member A communicated Baldt’s advice to Family Member B. Family Member B then passed Baldt’s advice to another family member (“Family Member C”). Family Member B later conveyed his advice to yet another family member.

8. Family Member A acted on Baldt’s October 3 tip as early as the first trading day after he tipped her. On October 6 and 7, she redeemed \$50,000 of Short-Term Fund shares each day, the maximum daily amount that could be redeemed telephonically. On October 6, Family Member B and Family Member C each redeemed \$50,000 of Short-Term Fund shares. Subsequently, Baldt’s family unsuccessfully attempted to redeem approximately \$3 million of Short-Term Fund shares.

9. At the time of Baldt’s October 3 conversation with Family Member A, Baldt possessed material non-public information regarding the Short-Term Fund, including knowledge of the rising level of redemption requests the Short-Term Fund had received and the likelihood either that the Short-Term Fund’s net asset value (“NAV”) would fall due to forced sales of large quantities of bonds to meet redemption requests or that the Short-Term Fund would suspend cash redemptions and force shareholders to accept redemptions “in-kind.”

10. By advising his family members to sell their shares while in possession of material non-public information, Baldt willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act.

**B. RESPONDENT**

11. **Baldt**, age 60, is a resident of Kennett Square, Pennsylvania. Between October 2003 and October 2008, Baldt was the Head of Municipal Bonds for Schroders and served as portfolio manager for the Funds. Baldt, who worked in Schroders Philadelphia office, also managed individual client accounts. On October 14, 2008, Baldt resigned as the Funds' portfolio manager but remained as a Schroders consultant until May 2009.

**C. OTHER RELEVANT ENTITIES**

12. **Schroders**, a registered investment adviser, is the United States arm of Schroders PLC, a global asset management company that manages approximately \$186.5 billion of assets globally. Schroders' offices are located in New York, New York and Philadelphia, Pennsylvania.

13. **The Funds** are registered open-end investment companies, which commenced operations on December 31, 2003 and entered liquidation on October 14, 2008. The Short-Term Fund had total net assets of \$150,160,255 as of September 30, 2008 and \$138,914,645 as of October 13, 2008.

**D. BACKGROUND**

14. Baldt joined Schroders in October 2003 to start Schroders' municipal bond business. In addition to serving as portfolio manager for the Funds, Baldt managed separate client accounts.

15. Baldt's family members invested the bulk of their life savings in the Short-Term Fund, and prior to September 2008, they made withdrawals periodically and only in response to particular cash needs.

16. In June 2008, the largest shareholder in the Intermediate Fund advised Schroders that it intended to redeem a significant portion of its investment in stages. In August 2008, the shareholder confirmed that it would redeem \$31.6 million and \$12.7 million on September 22 and 25, 2008, respectively, and that it would redeem substantial additional amounts in November 2008. By September 17, the shareholder informed Schroders that its November redemptions would total approximately \$60 million. Because the shareholder held approximately one third of the Intermediate Fund, its redemption requests concerned Schroders. By the time the shareholder had advised Schroders of these redemptions, the municipal bond market was suffering from limited liquidity. As Schroders and Baldt understood, an attempt to sell a substantial portion of the Intermediate Fund's portfolio of municipal bonds in such a market was likely to depress significantly the market prices of the bonds. The Short-Term Fund and the Intermediate Fund held a substantial number of overlapping bonds and thus a depressed market for the Intermediate Fund's bonds had the potential to affect the market for the Short-Term Fund's bonds as well.

17. In mid-September 2008, around the time of the bankruptcy of Lehman Brothers Holdings, Inc. and near failure of AIG, liquidity concerns severely escalated. Although

Baldt had been working toward meeting the upcoming redemption requests, as of September 17, 2008, the Intermediate Fund still had to raise approximately \$20 million to meet that single investor's September redemptions. In a meeting with Schrodgers' senior management on September 17, Baldt declared that the market for the Intermediate Fund's portfolio securities was "frozen." Baldt and senior management discussed alternatives for meeting the redemptions in light of market conditions, including the option of closing the Intermediate Fund. Schrodgers' management rejected the various alternatives on the table and directed Baldt to meet the redemptions by selling securities and raising cash.

**E. THE SEPTEMBER 17TH CONVERSATION**

18. On September 17, 2008, after his meeting with Schrodgers management regarding redemptions, Baldt returned a telephone call from Family Member A. During their conversation, Family Member A sought Baldt's advice as to what she should do with her investment in the Short-Term Fund, which constituted most of her life's savings. Family Member A began the conversation by asking Baldt, "So what are we going to do" about her "life savings." She asked whether he thought "we're okay" and whether it was bad for "our fund" that a certain money market fund had "broke[n] the buck." Responding to these questions, Baldt told Family Member A that, "well you should own what you could live with and if owning a Treasury makes you sleep better at night, just temporarily take haven in Treasury Bills."

19. When Family Member A expressed concern about selling her Short-Term Fund shares at a loss, Baldt told her, "[N]ever feel that way... always ignore your cost. It's -- that will keep you from doing what you need to do." He suggested to her that she set up an account and buy municipals backed by Treasuries. She responded, "Yeah. Hmm, that's a good idea. But you don't think I need to; it's just if I want to sleep at all at night?" He confirmed, "Well it sounds like you need to. . . You see you're so much -- you're up in the midst of all this and you can't be objective about it. . . But I -- well I think [Family Member B] feels the same way too, so I think you probably should do it. . . Both of you and [another family member], so that she doesn't worry about her either."

20. Subsequently, between September 17 and October 3, Family Member A relayed Baldt's advice to Family Member B. In addition, between September 17 and October 3, Family Member A made three telephonic redemptions for \$50,000 each, which was the maximum amount a shareholder could redeem by telephone per day.

**F. SCHRODERS' RESPONSES TO REDEMPTIONS**

21. On September 19, 2008, Schrodgers' CEO instructed senior management to create a contingency plan in the event that sufficient cash could not be raised in either of the Funds to meet upcoming redemptions. Although Baldt was not a member of this committee, he was involved in repeated high level phone calls as the crisis surrounding the Funds worsened, and the existence of the committee was widespread knowledge at Schrodgers.

22. At the outset, the committee concluded that if Baldt's portfolio team could not sell enough securities to meet incoming redemptions in either of the two Funds, then Schroders would liquidate both Funds.

23. In late September and early October 2008, liquidity worsened. Baldt led the Funds' portfolio team to increase its efforts to sell securities and raise the needed cash to meet redemptions. By Monday, September 29, Schroders' management was as concerned about sizable redemptions from its Short-Term Fund as it was from its Intermediate Fund.

24. On September 29, a member of the portfolio team told management that, "[w]e will face the same issues in terms of liquidity for the short fund." Management then reiterated its directive to Baldt that Baldt's portfolio team needed to sell securities and raise cash in each of the two Funds so that all redemptions could be met in an orderly fashion. In this email, management warned Baldt and his team that if they failed to raise the necessary cash, "the alternative may be to close the funds."

25. Baldt disagreed with management's directive to create a cash cushion and told them the course of action would force shareholders to "absorb[] large price declines as we sell into the vulture bids that are feasting on distressed sellers, knowing that the dealers cannot bid due to capital constraints." He detailed his view that large unit price declines would lead to added redemptions, further sales, and "snowballing poor investment performance" – which, he believed, would lead to a "rapid complete withdrawal of the remaining assets, forced liquidation into vulture bids, and massive declines in the principal value of the shares." He stated that this harm to the shareholders would be "far worse than freezing the funds' assets and seeking to liquidate them in an orderly fashion."

26. Management responded to Baldt by directing him to continue aggressively raising at least a 10% cash cushion in each of the two Funds in anticipation of known and possible redemption requests and to submit daily broad lists of securities seeking bids. Baldt's portfolio team spent the rest of that week attempting to raise the cash cushion in both Funds as management had directed.

27. On the morning of October 3, Baldt learned that a broker had determined that the Funds were seeking bids on significant portions of their bonds. During the week of September 29, 2008, in order to raise enough money to meet the cash cushion levels required by management, the Funds' portfolio team started soliciting bids from the broker community with respect to large lists of securities held in the portfolios of the two Funds. However, the team received few bids in response. On October 3, Baldt sent an email to Schroders' management to warn of the risks of continuing to put out large lists of securities, stating: "[T]he massive sale lists that we have recently undertaken in an attempt to implement within the week a large liquidity position have been identified by the dealer community as the Schroder portfolio. The assumption on their part now is that we are in trouble. . . If any of our advisors [investors] pick up on this, the result could be damaging." Schroders' management, however, pressed its existing directive to Baldt to sell securities.

28. Also on October 3, the Funds' portfolio team (including Baldt) was notified of an additional redemption from the Short-Term Fund in excess of \$1 million (which was approximately 0.7% of the Short-Term Fund's total assets). Baldt's portfolio team was also notified that day of another potentially large redemption from the Short-Term Fund in an unknown amount (which on October 6, the team learned was \$1.5 million).

**G. THE OCTOBER 3 CONVERSATION: BALDT TIPPED FAMILY MEMBER A TO SELL ALL OF HER SHARES**

29. After the market closed on October 3, Baldt and Family Member A had a telephone conversation. Family Member A called Baldt to talk about an investment unrelated to the Short-Term Fund. After briefly discussing this unrelated investment, Baldt changed the subject and said: "And, you know, your holdings of municipals that you have [referring to the Short-Term Fund], you really should, you know, consider your inclination to sell that . . . Don't -- don't ever be afraid -- never let taking a loss get into your consideration." After Family Member A told Baldt that she had sold some of her shares, Baldt said, "Well I'd go the full route. And [Family Member B], you know, that's -- I think she's -- the way she worries, she ought to do it as well." Family Member A responded that she had already told Family Member B about Baldt's recommendation to sell. Family Member A then said that she "wanted to diversify a little bit right now" because "even though the bonds behind them are probably really still good, just in case, like there's a run on the fund." Baldt answered her, "Yeah... No. Do what you're -- go with your original thought on it and -- tell her [Family Member B] the same thing."

30. Family Member A understood Baldt's advice to "go the full route" as a recommendation that she should sell all of her shares in the Short-Term Fund. On the evening of October 3, Family Member A conveyed to Family Member B what Baldt had told her. During the October 4-5 weekend, Family Member B told Family Member C about the October 3 conversation between Baldt and Family Member A, and also said that both Family Member A and Family Member B had decided to redeem all of their Short-Term Fund shares. Family Member C then also decided to redeem at least some of her shares. Thus, as a result of Baldt's October 3 call, Family Members A, B and C each redeemed shares from the Short-Term Fund. In addition, within days after the October 3 call, Family Member B told another Baldt family member that she was going to redeem her shares in the Short-Term Fund. Thereafter, the other family member attempted unsuccessfully to redeem all of her and her husband's shares in the Short-Term Fund.

**H. BALDT'S FAMILY REDEEMS**

31. On October 6 and October 7, the trading days immediately following the October 3 call, Family Member A telephonically redeemed another \$50,000 each day, at \$9.20 and \$9.17 per share, respectively. Also on October 6, Family Members B and C each redeemed \$50,000 of shares telephonically, both at \$9.20 per share. These redemptions, totaling \$200,000, were successfully fulfilled.

32. Subsequently, Baldt's family members attempted, but failed, to redeem \$3,068,117 worth of Short-Term Fund shares.

33. On October 13, 2008, a large Intermediate Fund investor notified Schroders that it would redeem \$33 million in two days. Given that redemption notice and the pre-existing notice of other redemptions, Schroders decided to close both Funds. It announced its decision to shareholders on October 14. On October 13 and 14, the Short-Term Fund's NAV was \$8.91 and \$8.85 per share, respectively.

## **I. VIOLATIONS**

34. Baldt knew or was reckless in not knowing that tipping his Family Members to sell their shares on October 3 constituted a breach of his fiduciary duties to the Short-Term Fund and Schroders in that it entailed misuse of confidential information concerning the Short-Term Fund for the benefit of his family. As of October 3, Baldt was aware that the Funds faced two options: the Funds could either remain open, which Baldt believed would result in a significant drop in the Funds' NAV, or the Funds would be liquidated in an orderly fashion, resulting in near-term illiquidity for shareholders, if redemptions only were to be made "in-kind," on a pro rata basis.

35. At the time of his October 3 conversation with Family Member A, Baldt possessed material non-public information concerning the Short-Term Fund. He knew the Short-Term Fund was receiving mounting and significant redemption requests at a time when sales of portfolio securities were adding downward pressure on municipal bond prices. Not only were market conditions rapidly deteriorating, but brokers had extremely limited capital with which to bid on bonds (meaning that regardless of the type of bond the team was attempting to sell, they were likely to get little, if any, interest to purchase that bond). Baldt also knew that Schroders' management had directed that the Funds sell enough portfolio securities to maintain a 10-12% cash cushion, which put additional pressure on the Fund to sell its most liquid assets into a declining market. Despite his team's attempt to quietly sell a large portion of the Funds' portfolio securities, he knew that very few bids had been received. When Baldt learned that a broker had discovered that Schroders was putting out a large percentage of its municipal bond portfolio to bid and questioned whether Schroders was in trouble, he knew that such information, if it became known by investors, would likely cause redemption requests to increase. Schroders' management had directed him to continue selling Fund securities despite the likelihood that investors would learn of the Fund's liquidity crisis and begin to redeem. Concerned that this course of conduct would cause near-term, detrimental harm to the Fund and its shareholders, Baldt tipped Family Member A to redeem all of her shares in the Fund and told her to advise another family member to do the same.

36. As a result of the conduct described above, Baldt willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities. Baldt owed Schroders and the Short-Term Fund a fiduciary duty and breached that duty when he advised Family Member A and, through her, Family Member B, to sell their shares in the Short-Term Fund while in possession of material non-public information regarding the Short-Term Fund.

37. As a result of the conduct described above, Baldt also willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an

investment adviser. By tipping his family members to sell their shares while in possession of material non-public information, Baldt breached his fiduciary duty to the Short-Term Fund and committed a fraud on the Short-Term Fund.

### III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

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

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 203(f) of the Advisers Act including, but not limited to, civil penalties pursuant to Section 203(i) of the Advisers Act;

C. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 9(b) of the Investment Company Act including, but not limited to, civil penalties pursuant to Section 9(d) of the Investment Company Act; and

D. Whether, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, and Section 203(k) of the Advisers Act Respondent should be ordered to cease and desist from committing or causing violations of and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act, and whether Respondent should be ordered to pay disgorgement pursuant to Section 8A(e) of the Securities Act and Section 21C(e) of the Exchange Act.

### IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

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

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

This Order shall be served forthwith upon Respondent personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

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

By the Commission.

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. 62077 / May 11, 2010**

**ADMINISTRATIVE PROCEEDING**

**File No. 3-13888**

**In the Matter of**

**BCI Telecom Holding, Inc.,  
Bonanza Explorations, Inc.  
(f/k/a Copperstone Resources Corp.)  
(n/k/a Bonanza Resources Corp.),  
Bonaventure Resources, Inc.,  
British American Holdings, Ltd.,  
British-American Insurance Company, Ltd.,  
BT Energy Corp.,  
Butterfield Preferred Growth Fund 83, and  
By George Holding Corp.  
(n/k/a AMR Meridian, 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 BCI Telecom Holding, Inc., Bonanza Explorations, Inc. (f/k/a Copperstone Resources Corp.) (n/k/a Bonanza Resources Corp.), Bonaventure Resources, Inc., British American Holdings, Ltd., British-American Insurance Company, Ltd., BT Energy Corp., Butterfield Preferred Growth Fund 83, and By George Holding Corp. (n/k/a AMR Meridian, Inc.).

**II.**

After an investigation, the Division of Enforcement alleges that:

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## A. RESPONDENTS

1. BCI Telecom Holding, Inc. (CIK No. 921095) is a Montreal, Quebec, Canada corporation located in Montreal, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). BCI Telecom Holding is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 40-F for the period ended December 31, 2001, which reported a net loss of \$27,434,000 for the prior three months

2. Bonanza Explorations, Inc. (f/k/a Copperstone Resources Corp.) (n/k/a Bonanza Resources Corp.) (CIK No. 1011030) is a British Columbia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Bonanza Explorations is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended October 31, 1997, which reported a net loss of \$5,888,336 for the prior twelve months. As of May 6, 2010, the company's stock (symbol "BRSUF") was traded on the over-the-counter markets.

3. Bonaventure Resources, Ltd. (CIK No. 910881) is a British Columbia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Bonaventure Resources is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-FR registration statement on March 24, 1994, which reported a net loss of \$1,548,131 for the prior nine months.

4. British American Holdings, Ltd. (CIK No. 880365) is a Bahamas corporation located in Nassau, Bahamas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). British American Insurance is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended December 31, 1994.

5. British-American Insurance Company, Ltd. (CIK No. 14294) is a Bahamas corporation located in Nassau, Bahamas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). British American Insurance is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended December 31, 1997.

6. BT Energy Corp. (CIK No. 716786) is a void Delaware corporation located in Independence, Ohio with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). BT Energy 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, 1995, which reported a net loss of \$143,000 for the prior three months.

7. Butterfield Preferred Growth Fund 83 (CIK No. 355809) is a cancelled California corporation located in Vancouver, Washington with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Butterfield is

delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 1994.

8. By George Holding Corp. (n/k/a AMR Meridian, Inc.) (CIK No. 1111246) is a dissolved Georgia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). By George 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 October 31, 2000.

#### B. DELINQUENT PERIODIC FILINGS

9. 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.

10. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports and Rule 13a-13 requires domestic issuers to file quarterly reports. Rule 13a-16 requires foreign private issuers to furnish quarterly and other reports to the Commission under cover of Form 6-K if they make or are required to make the information public under the laws of the jurisdiction of their domicile or in which they are incorporated or organized; if they file or are required to file information with a stock exchange on which their securities are traded and the information was made public by the exchange; or if they distribute or are required to distribute information to their security holders.

11. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 or 13a-16 thereunder.

### III.

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

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

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

Respondents identified in Section II, 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 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**

*Commissioner Watter  
not participating*

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 62088 / May 12, 2010

ADMINISTRATIVE PROCEEDING

File No. 3-11935

In the Matter of

**Smith Barney Fund Management  
LLC and Citigroup Global Markets  
Inc.,**

Respondents.

**ORDER DIRECTING  
DISBURSEMENT OF FAIR FUND**

On January 7, 2010, the Commission published a notice of the Plan of Distribution ("Plan") proposed by the Division of Enforcement in connection with this proceeding (Exchange Act Release No. 61312). On February 25, 2010, the Commission extended the comment period by 30 days (Exchange Act Release No. 61587). The Commission received no comments and on April 15, 2010, the Plan was approved pursuant to delegated authority (Exchange Act Release No. 61917).

The Plan provides for the distribution of disgorgement-related portions of the Fair Fund to funds from the Smith Barney Family of Funds (the "Funds") that engaged a Citigroup affiliate, Citicorp Trust Bank fsb or a predecessor entity (collectively, "CTB"), as their transfer agent and paid transfer agent fees to CTB between October 1, 1999, and November 30, 2004, or to successors to such Funds, in proportion to the total transfer agent fees paid to CTB by each Fund or class of a Fund (subject to certain adjustments). Further, the Respondents have advanced estimated distribution amounts to Funds that were liquidated after the initial submission of the Plan but before the distribution. Under the Plan, the Respondents will recover the amounts advanced to those liquidated Funds, plus interest. Funds that were liquidated prior to the initial submission of the Plan in August 2005 will not participate in the proposed distribution.

The Plan provides that the Commission will arrange for disbursement from the Fair Fund when the Approved Payment File listing the payees with the identification information required to make the distribution has been received and accepted. The Approved Payment File for the distribution in the amount of \$110,782,362.95 has been received and accepted.

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Accordingly, it is ORDERED that the Commission staff shall transfer \$110,782,362.95 of the Fair Fund to the custodians for the entitled funds and that these custodians shall distribute such monies, as provided for in the Plan of Distribution.

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. 62090 / May 12, 2010

Administrative Proceeding  
File No. 3-11726

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In the Matter of:

FREMONT INVESTMENT  
ADVISORS, INC.

NOTICE OF PROPOSED PLAN OF  
DISTRIBUTION AND OPPORTUNITY  
FOR COMMENT

Respondent.

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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 monies in *In the Matter of Fremont Investment Advisors, Inc.* The Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 203(e) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and Issuing a Cease-and-Desist Order, Administrative Proceeding File No. 3-11726 in this matter on November 4, 2004 (Advisers Act Release No. 2317) (the "Order").

**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 Michael S. Dicke, United States Securities and Exchange Commission, 44 Montgomery Street, Suite 2600, San Francisco, CA 94104. Further, all persons desiring to comment on the Distribution Plan may submit their comments, in writing, within 30 days of 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

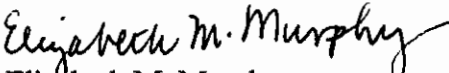
3. by sending an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov).

Comments submitted by email or via the Commission's website should include "Administrative Proceeding File Number 3-11726" 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 disgorgement of \$2,146,000 paid by Fremont, and a civil money penalty in the amount of \$2 million, plus any accumulated interest, less any federal, state, or local taxes on the interest. The proposed plan provides for distribution of the Fair Fund to eligible investors in the Fremont U.S. Micro-Cap Fund and the Fremont Global Fund to compensate them for losses resulting from market timing and late trading. If the Distribution Plan is approved, eligible investors will receive a fair and proportionate share of the Fair Fund as calculated by the Independent Distribution Consultant. The distribution amount will be calculated from information in Fremont Mutual Funds' 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  
Secretary



**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**INVESTMENT ADVISERS ACT OF 1940**  
**Release No. 3025 / May 12, 2010**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-13889**

**In the Matter of**

**DIEGO M. ROLANDO,**

**Respondent.**

**ORDER INSTITUTING**  
**ADMINISTRATIVE PROCEEDINGS**  
**PURSUANT TO SECTION 203(f) OF THE**  
**INVESTMENT ADVISERS ACT OF 1940,**  
**MAKING FINDINGS, AND IMPOSING**  
**REMEDIAL SANCTIONS**

**I.**

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Diego M. Rolando ("Respondent" or "Rolando").

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

**III.**

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

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1. Respondent, age 30, is an unregistered investment adviser who maintained websites that he used to promote his advisory services in the U.S., Argentina and around the world. Rolando is a citizen of Argentina who resides in Buenos Aires.

2. On December 10, 2008, in the civil action entitled *U.S. Commodity Futures Trading Commission v. Rolando*, Civil Action Number 3:08-CV-0064 (MRK), the United States District Court for the District of Connecticut issued a judgment against the Respondent finding that he willfully violated Sections 4b(a) and 4c(b) of the Commodity Exchange Act, as amended, 7 U.S.C §§ 6b(a) and 6c(b), and § 33.10(a)-(c) of the United States Commodity Futures Trading Commission's Regulations, 17 C.F.R § 33.10(a)-(c) 2007. The Court also, among other things, permanently enjoined Rolando from future violations of the above-listed sections of the Commodity Exchange Act and the rules thereunder.

3. According to the District Court's judgment, from 2005 to 2007 Rolando obtained approximately \$34 million from 420 investors residing in Argentina, the U.S., and around the world. In his scheme, Rolando purported to operate through an entity named IA Trading and a trading platform at a website with the address IA Trading.com. Rolando opened trading accounts at an online securities and commodities broker with offices in Connecticut and Chicago.

4. The District Court also found that Rolando represented to investors that he would invest in highly rated stocks and indexes and that such trading would take place exclusively through the NYSE or NASDAQ. Contrary to his representations, Rolando traded in futures and options, incurring trading losses of approximately \$10.6 million of the \$34 million that had been invested with him. To conceal the losses, Rolando provided false account statements. These false account statements misrepresented that investor funds were entirely invested in securities, when according to the actual account records, futures and options accounted for over 95% of the notional value traded in client accounts.

5. On January 15, 2008, the United States Commodity Futures Trading Commission filed an action against Rolando seeking preliminary and permanent injunctions, the appointment of a temporary receiver, and other relief. On the same day, the Court appointed a receiver for the funds Rolando managed. Rolando did not appear in the action and the Court entered a default judgment against him on December 10, 2008. In addition to the permanent injunctions entered against Rolando, the Court ordered the return of funds to customers, restitution of \$197,125.52 in commissions that Rolando collected, prejudgment interest, and a civil money penalty of \$10 million.

#### IV.

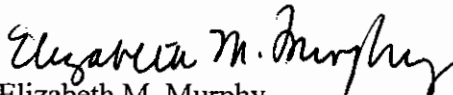
In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(f) of the Advisers Act, that Respondent Rolando be, and hereby is barred from association with any investment adviser.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission or the United States Commodity Futures Trading 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

**ESTADOS UNIDOS DE AMÉRICA**  
Ante la  
**COMISIÓN DE BOLSAS Y VALORES**

**LEY DE ASESORES DE INVERSIONES DE 1940**  
Comunicado N°. 3025 / May 12, 2010

**PROCESO ADMINISTRATIVO Archivo N°.**  
**3-13889**

**En el asunto de**

**DIEGO M. ROLANDO,**

**Demandado.**

**ORDEN DE INICIAR PROCESOS  
ADMINISTRATIVOS, DE CONFORMIDAD  
CON LA SECCIÓN 203(f) DE LA LEY DE  
ASESORES DE INVERSIONES DE 1940,  
QUE REALICEN HALLAZGOS E  
IMPONGAN SANCIONES CORRECTIVAS**

**I.**

La Comisión de Bolsas y Valores ("Comisión") considera apropiado y de interés público que se inicien procesos administrativos públicos por medio de la presente, de conformidad con la Sección 203(f) de la Ley de asesores de inversiones de 1940 ("Ley de Asesores") contra Diego M. Rolando ("Demandado" o "Rolando").

**II.**

En anticipación del inicio de estos procesos, el Demandado ha presentado una Oferta de Resolución (la "Oferta") que la Comisión ha determinado aceptar. Únicamente para los fines de estos procesos y de cualquier otro proceso entablado por o en nombre de la Comisión, o de los cuales participe la Comisión, y sin admitir ni negar los hallazgos de los mismos, excepto con respecto a la jurisdicción de la Comisión sobre él y sobre la materia objeto de estos procesos, y los hallazgos incluidos en la Sección III.2 que se mencionan a continuación, que se admiten, el Demandado acepta el ingreso de esta Orden para iniciar Procesos Administrativos de conformidad con la Sección 203(f) de la Ley de asesores de inversiones de 1940, a realizar hallazgos e imponer sanciones correctivas ("Orden"), tal como se establece a continuación.

**III.**

Sobre la base de esta Orden y de la Oferta del Demandado, la Comisión establece que:

1. El Demandado, de 30 años de edad, es un asesor de inversión no registrado que mantenía sitios en la Internet que utilizaba para promocionar sus servicios de asesoramiento en los Estados Unidos, Argentina y otras partes del mundo. Rolando es un ciudadano argentino que reside en Buenos Aires.

2. El 10 de diciembre de 2008, en la demanda civil titulada *U.S. Commodity Futures Trading Commission v. Rolando*, Demanda Civil Número 3:08-CV-0064 (MRK), el Tribunal de Distrito de Estados Unidos del Distrito de Connecticut emitió un juicio contra el Demandado luego de hallar que había violado deliberadamente las Secciones 4b(a) y 4c(b) de la Ley de la bolsa de mercancías, y enmiendas, 7 U.S.C §§ 6b(a) y 6c(b), y § 33.10(a)-(c) de los Reglamentos de la Agencia reguladora de los mercados de futuros de los Estados Unidos, 17 C.F.R § 33.10(a)-(c) 2007. El Tribunal también prohibió permanentemente a Rolando, entre otras cosas, que violara en el futuro las secciones arriba mencionadas de la Ley de la bolsa de mercancías y las normas de la misma.

3. Según el dictamen del Tribunal de Distrito, entre 2005 y 2007 Rolando obtuvo aproximadamente 34 millones de dólares de 420 inversionistas residentes en Argentina, los EE.UU. y otras partes del mundo. Con esta estratagema, Rolando pensaba operar a través de una entidad llamada IA Trading y una plataforma de operaciones en un sitio de Internet con la dirección IA Trading.com. Rolando abrió cuentas de operaciones con un agente de valores y productos básicos en la Internet con oficinas en Connecticut y Chicago.

4. El Tribunal del Distrito también determinó que Rolando afirmó a los inversionistas que invertiría en índices y acciones de alta calificación y que dichas operaciones se producirían exclusivamente a través de la Bolsa de Valores de Nueva York (NYSE) o el NASDAQ. Pese a lo afirmado, Rolando realizó operaciones en futuros y opciones, y contrajo pérdidas de aproximadamente 10,6 millones de dólares de los 34 millones de dólares que había recibido en inversiones. Para esconder las pérdidas, Rolando presentó estados de cuenta falsos. Estos estados de cuenta falsos mostraban de manera errónea que los fondos de los inversionistas se habían invertido exclusivamente en títulos, mientras que los verdaderos registros de cuentas demostraban que los futuros y las opciones representaban alrededor del 95% del valor hipotético negociado en las cuentas de los clientes.

5. El 15 de enero de 2008, la Agencia reguladora de los mercados de futuros en los Estados Unidos entabló una demanda contra Rolando para obtener interdictos provisorios y permanentes, la designación de un administrador judicial temporal y otros desagavios. En la misma fecha, el Tribunal designó un administrador judicial de los fondos que Rolando administraba. Rolando no compareció en la demanda y el Tribunal inicio un juicio por incomparecencia en su contra el 10 de diciembre de 2008. Además de los interdictos provisorios y permanentes que se iniciaron contra Rolando, el Tribunal ordenó el reintegro de los fondos a los clientes, la restitución de 197.125,52 dólares en comisiones que Rolando cobró, intereses antes de la sentencia y una indemnización civil de 10 millones de dólares.

#### IV.

Sobre la base de lo anterior, la Comisión considera apropiado y de interés público imponer las sanciones acordadas en la Oferta del Demandado.

Por consiguiente, por medio de la presente, se ORDENA que:

De conformidad con la Sección 203(f) de La Ley de Asesores, el Demandado Rolando tiene prohibido, por medio de la presente, asociarse con un asesor de inversiones.

Todo nuevo intento de solicitud de asociación por parte del Demandado estará sujeto a las leyes y reglamentos pertinentes que rigen el proceso de reingreso, y el reingreso puede verse condicionado por una serie de factores, lo que incluye pero no se limita al cumplimiento de cualquiera de las siguientes opciones: (a) toda devolución dictaminada en perjuicio del Demandado, sin importar si la Comisión o si la Agencia reguladora de los mercados de futuros en los Estados Unidos hayan renunciado o no, total o parcialmente, al pago de dicha devolución; (b) toda sentencia arbitral relacionada con la conducta que sirva como base de la orden de la Comisión; (c) toda sentencia arbitral de una organización autorregulada a un cliente, sin importar si se relaciona o no con la conducta que sirvió como base de la orden de la Comisión; y (d) toda orden de restitución por parte de una organización autorregulada, sin importar si se relaciona o no con la conducta que sirvió como base de la orden de la Comisión.

Por la Comisión.

Elizabeth M. Murphy  
Secretaria

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**May 13, 2010**

**In the Matter of**

**BVR Technologies Ltd.**  
**(n/k/a Technoprises Ltd.),**  
**Crystal Graphite Corp.,**  
**Devine Entertainment Corp.,**  
**GEE TEN Ventures, Inc.,**  
**National Construction, Inc.**  
**(n/k/a E.G. Capital, Inc.),**  
**SHEP Technologies, Inc., and**  
**WHEREVER.Net Holding 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 BVR Technologies Ltd. (n/k/a Technoprises Ltd.) because it has not filed any periodic reports since the period ended December 31, 2004.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Crystal Graphite Corp. because it has not filed any periodic reports since the period ended August 31, 2004.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Devine Entertainment Corp. because it has not filed any periodic reports since the period ended September 30, 2008.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of GEE TEN Ventures, Inc. because it has not filed any periodic reports since the period ended May 31, 2004.

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It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of National Construction, Inc. (n/k/a E.G. Capital, Inc.) because it has not filed any periodic reports since the period ended February 28, 2003.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of SHEP Technologies, Inc. because it has not filed any periodic reports since the period ended December 31, 2004.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of WHEREVER.Net Holding Corp. because it has not filed any periodic reports since it filed a Form 8-A on April 26, 2000.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on May 13, 2010 and terminating at 11:59 p.m. EDT on May 26, 2010.

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. 62092 / May 13, 2010**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-13892**

**In the Matter of**

**BVR Technologies Ltd.**  
**(n/k/a Technoprises Ltd.),**  
**Crystal Graphite Corp.,**  
**Devine Entertainment Corp.,**  
**GEE TEN Ventures, Inc.,**  
**National Construction, Inc.**  
**(n/k/a E.G. Capital, Inc.),**  
**SHEP Technologies, Inc., and**  
**WHEREVER.Net Holding Corp.,**

**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 BVR Technologies Ltd. (n/k/a Technoprises Ltd.), Crystal Graphite Corp., Devine Entertainment Corp., GEE TEN Ventures, Inc., National Construction, Inc. (n/k/a E.G. Capital, Inc.), SHEP Technologies, Inc., and WHEREVER.Net Holding Corp.

**II.**

After an investigation, the Division of Enforcement alleges that:

**A. RESPONDENTS**

1. BVR Technologies Ltd. (n/k/a Technoprises Ltd.) ("TNOLF")<sup>1</sup> (CIK No. 874516) is an Israeli corporation located in Tel Aviv, Israel with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). TNOLF is

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<sup>1</sup>The short form of each issuer's name is also its stock symbol.

delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended December 31, 2004, which reported a net loss of \$20,411,000 for the period from inception through December 31, 2004. As of May 6, 2010, the common stock of TNOLF was quoted on the Pink Sheets operated by Pink OTC Markets Inc. ("Pink Sheets"), had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Crystal Graphite Corp. ("CYTGF") (CIK No. 1077295) is a British Columbia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CYTGF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended August 31, 2004, which reported a net loss of \$2,991,438 (Canadian) for the prior year. As of May 6, 2010, the common stock of CYTGF 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).

3. Devine Entertainment Corp. ("DVNNF") (CIK No. 1317035) is an Ontario corporation located in Toronto, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DVNNF 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, 2008, which reported a net loss of \$3,980,387 (Canadian) for the prior nine months. As of May 6, 2010, the common stock of DVNNF was quoted on the Pink Sheets, had ten market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. GEE TEN Ventures, Inc. ("GEEVF") (CIK No. 1076234) is a British Columbia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GEEVF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended May 31, 2004, which reported a net loss of \$639,538 (Canadian) for the prior year. As of May 6, 2010, the common stock of GEEVF 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).

5. National Construction, Inc. (n/k/a E.G. Capital, Inc.) ("EGCFF") (CIK No. 1003112) is an Ontario corporation located in Brossard, Quebec, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). EGCFF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended February 28, 2003, which reported a net loss of \$4,143,000 (Canadian) for the prior year. On March 18, 2005 EGCFF changed its name to E.G. Capital, Inc. but failed to report that change to the Commission on Form 6-K as required by Commission rules. As of May 6, 2010, the common stock of EGCFF 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).

6. SHEP Technologies, Inc. ("STLOF") (CIK No. 1135443) is a Yukon corporation located in Vancouver, British Columbia, Canada with a class of securities

registered with the Commission pursuant to Exchange Act Section 12(g). STLOF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended December 31, 2004, which reported a net loss of \$1,905,219 for the prior year. As of May 6, 2010, the common stock of STLOF 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).

7. WHEREVER.Net Holding Corp. ("WNETY") (CIK No. 1109542) is a Cayman Islands corporation located in Hong Kong with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). WNETY is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 8-A on April 26, 2000. As of May 6, 2010, the common stock of WNETY was quoted on the Pink Sheets, had two market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

#### B. DELINQUENT PERIODIC FILINGS

8. As described 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.

9. 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 domestic issuers to file quarterly reports. Rule 13a-16 requires foreign private issuers to furnish quarterly and other reports to the Commission under cover of Form 6-K if they make or are required to make the information public under the laws of the jurisdiction of their domicile or in which they are incorporated or organized; if they file or are required to file information with a stock exchange on which their securities are traded and the information was made public by the exchange; or if they distribute or are required to distribute information to their security holders.

10. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 or 13a-16 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

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

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**

**Release No. 62107 / May 13, 2010**

**ADMINISTRATIVE PROCEEDING**

**File No. 3-13900**

**In the Matter of**

**Brokat Technologies Aktiengesellschaft,**

**Respondent.**

**ORDER INSTITUTING  
ADMINISTRATIVE PROCEEDINGS  
AND NOTICE OF HEARING  
PURSUANT TO SECTION 12(j) OF  
THE SECURITIES EXCHANGE ACT  
OF 1934**

**I.**

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent Brokat Technologies Aktiengesellschaft.

**II.**

After an investigation, the Division of Enforcement alleges that:

**A. RESPONDENT**

1. Brokat Technologies Aktiengesellschaft (CIK No. 1071486) is a German corporation located in Stuttgart, Germany with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Brokat is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended December 31, 2000, which reported a net loss of \$246,284,000 for the prior twelve months.

**B. DELINQUENT PERIODIC FILINGS**

2. As discussed in more detail above, the Respondent is delinquent in its periodic filings with the Commission, have repeatedly failed to meet its obligations to file

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timely periodic reports, and failed to heed a delinquency letter sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations or, through its failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

12. 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-16 requires foreign private issuers to furnish quarterly and other reports to the Commission under cover of Form 6-K if they make or are required to make the information public under the laws of the jurisdiction of their domicile or in which they are incorporated or organized; if they file or are required to file information with a stock exchange on which their securities are traded and the information was made public by the exchange; or if they distribute or are required to distribute information to their security holders.

13. As a result of the foregoing, Respondent failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-16 thereunder.

### III.

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

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

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondent identified in Section II, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of the Respondent.

### IV.

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

IT IS HEREBY FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of 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**

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**

**Release No. 62104 / May 13, 2010**

**ADMINISTRATIVE PROCEEDING**

**File No. 3-13899**

**In the Matter of**

**Ultrafem, Inc.,  
Underwriters Financial Group, Inc.,  
Unigas E&P, Inc.,  
United Petroleum Corp., and  
United Resources, 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 Ultrafem, Inc., Underwriters Financial Group, Inc., Unigas E&P, Inc., United Petroleum Corp., and United Resources, Inc.

**II.**

After an investigation, the Division of Enforcement alleges that:

**A. RESPONDENTS**

1. Ultrafem, Inc. (CIK No. 892142) is a forfeited Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Ultrafem 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 31, 1997, which reported a net loss of \$19,854,903 for the prior six months. On April 1, 1998, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of New York, and the case was terminated on October 25, 2002.

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2. Underwriters Financial Group, Inc. (CIK No. 871424) is a dissolved Colorado corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Underwriters Financial Group is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 1995, which reported a net loss of \$162,790 for the prior three months. On December 11, 1995, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of New York, and the case was terminated on June 7, 2002.

3. Unigas E&P, Inc. (CIK No. 317810) is a permanently revoked Nevada corporation located in Naples, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Unigas E&P is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 1998, which reported a net loss of \$490,019 for the prior nine months. As of May 11, 2010, the company's stock (symbol "CRON") was traded on the over-the-counter markets.

4. United Petroleum Corp. (CIK No. 82925) is a forfeited Delaware corporation located in Miami, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). United Petroleum 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 June 10, 2001, which reported a net loss of \$4,438,000 for the prior forty weeks. On October 30, 2001, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Delaware, and the case was terminated on December 9, 2002. As of May 11, 2010, the company's stock (symbol "UTDP") was traded on the over-the-counter markets.

5. United Resources, Inc. (CIK No. 101473) is a Florida corporation located in Miami, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). United Resources 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 31, 1992, which reported a net loss of \$963,152 for the prior six months.

## B. DELINQUENT PERIODIC FILINGS

6. As discussed in more detail above, all of the respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

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

8. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

### III.

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

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

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

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

May 14, 2010

In the Matter of

Broadengate Systems, Inc.,  
(n/k/a Otter Lake Resources, Inc.),

File No. 500-1

ORDER OF SUSPENSION OF  
TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Broadengate Systems, Inc. (n/k/a Otter Lake Resources, Inc.) because it has not filed any periodic reports since the period ended September 30, 2002.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed company. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EDT on May 14, 2010 and terminating at 11:59 p.m. EDT on May 27, 2010.

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. 62111 / May 14, 2010**

**ADMINISTRATIVE PROCEEDING**

**File No. 3-13902**

**In the Matter of**

**Broadengate Systems, Inc.**  
**(n/k/a Otter Lake Resources, Inc.)**

**Respondent.**

**ORDER INSTITUTING  
ADMINISTRATIVE  
PROCEEDINGS AND NOTICE  
OF HEARING PURSUANT TO  
SECTION 12(j) OF THE  
SECURITIES EXCHANGE ACT  
OF 1934**

**I.**

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent Broadengate Systems, Inc. (n/k/a Otter Lake Resources, Inc.).

**II.**

After an investigation, the Division of Enforcement alleges that:

**A. RESPONDENT**

1. Broadengate Systems, Inc. (n/k/a Otter Lake Resources, Inc.) ("OTLK")<sup>1</sup> (CIK No. 862475) is a defaulted Nevada corporation located in Shenzhen, China with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). OTLK 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, 2002, which reported a net loss of \$638,750 for the prior nine months. In November 2006, OTLK changed its name in the Pink Sheets to Otter Lake Resources, Inc. but failed to report that change to the Commission on Form 8-K or record it in the Commission's EDGAR database, as required by Commission rules. As of May 12, 2010, the common stock of OTLK was quoted on the Pink Sheets operated by Pink OTC Markets Inc., had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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<sup>1</sup>The short form of each issuer's name is also its stock symbol.

**B. DELINQUENT PERIODIC FILINGS**

2. As discussed in more detail above, the Respondent is delinquent in its periodic filings with the Commission, has repeatedly failed to meet its obligations to file timely periodic reports, and, through its failure to maintain a valid address on file with the Commission as required by Commission rules, failed to receive the delinquency letter sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations.

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

4. As a result of the foregoing, the Respondent failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

**III.**

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

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

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondent identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of the Respondent.

**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 the Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of 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, 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

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

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 62109 / May 14, 2010**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-13901**

**In the Matter of**

**China Technology Global Corp.,**

**Respondent.**

**ORDER INSTITUTING  
ADMINISTRATIVE  
PROCEEDINGS AND NOTICE OF  
HEARING PURSUANT TO  
SECTION 12(j) OF THE  
SECURITIES EXCHANGE ACT  
OF 1934**

**I.**

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent China Technology Global Corp.

**II.**

After an investigation, the Division of Enforcement alleges that:

**A. RESPONDENT**

1. China Technology Global Corp. ("CTGLF")<sup>1</sup> (CIK No. 1021126) is a British Virgin Islands corporation located in Shen Zhen, Guang Dong Province, China with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CTGLF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended March 31, 2005. As of May 6, 2010, the common stock of CTGLF was quoted on the Pink Sheets operated by Pink OTC Markets Inc., had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

**B. DELINQUENT PERIODIC FILINGS**

2. As discussed in more detail above, the Respondent is delinquent in its periodic filings with the Commission, has repeatedly failed to meet its obligations to file timely periodic

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<sup>1</sup>The short form of each issuer's name is also its stock symbol.



reports and, through its failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive the delinquency letter sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations.

3. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports. Rule 13a-16 requires foreign private issuers to furnish quarterly and other reports to the Commission under cover of Form 6-K if they make or are required to make the information public under the laws of the jurisdiction of their domicile or in which they are incorporated or organized; if they file or are required to file information with a stock exchange on which their securities are traded and the information was made public by the exchange; or if they distribute or are required to distribute information to their security holders.

4. As a result of the foregoing, the Respondent failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-16 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 Respondent an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondent identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of the Respondent.

### IV.

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

IT IS HEREBY FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent, and any successor under Exchange Act Rules 12b-2 or 12g-

3, and any new corporate names of 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 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**

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

May 14, 2010

In the Matter of  
China Technology Global 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 China Technology Global Corp. because it has not filed any periodic reports since the period ended March 31, 2005.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed company. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EDT on May 14, 2010 and terminating at 11:59 p.m. EDT on May 27, 2010.

By the Commission.

Elizabeth M. Murphy  
Secretary

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

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-62114; File No. 265-26]

**COMMODITY FUTURES TRADING COMMISSION**

**Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues**

**AGENCIES:** Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC") (each, an "Agency," and collectively, "Agencies").

**ACTION:** Notice of Meeting of Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues.

**SUMMARY:** The Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues is providing notice that it will hold a public meeting on Monday, May 24, 2010, in the Auditorium, Room L-002, at the SEC's main offices, 100 F Street, NE, Washington, DC. The meeting will begin at 9:00 a.m. (EST) and will be open to the public. The Committee meeting will be webcast on the SEC's Web site at <http://www.sec.gov>. Persons needing special accommodations to take part because of a disability should notify a contact person listed below. The public is invited to submit written statements to the Committee.

The agenda for the meeting includes: (i) opening remarks; (ii) the introduction of Committee members, (iii) discussion of Committee agenda and organization; (iv) discussion of the Joint CFTC-SEC staff report on the market events of May 6, 2010; and (v) discussion of next steps and closing comments.

Pursuant to 41 CFR Section 102-3.150(b), the Agencies are providing less than fifteen days notice of the meeting so that Committee members can quickly begin to conduct a review of the market events of May 6, 2010, and make recommendations

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related to market structure issues that may have contributed to the volatility, as well as disparate trading conventions and rules across various markets.

**DATES:** Written statements should be received on or before noon on Friday, May 21, 2010.

**ADDRESSES:** Because the Agencies will jointly review all comments submitted, interested parties may send comments to either Agency and need not submit responses to both Agencies. Respondents are encouraged to use the title "Joint CFTC-SEC Advisory Committee" to facilitate the organization and distribution of comments between the Agencies. Interested parties are invited to submit responses to:

Securities and Exchange Commission: Written comments may be submitted by the following methods:

Electronic Comments

- Use the SEC's Internet submission form (<http://www.sec.gov/rules/other.shtml>);
- or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov).

Please include File No. 265-26 on the subject line.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F St., NE, Washington 20549. All submissions should refer to File No. 265-26.

To help the SEC process and review your comments more efficiently, please use only one method. The SEC staff will post all comments on the SEC's Internet Web site

(<http://www.sec.gov/rules/other.shtml>). Comments will also be available for Web site

viewing and printing in the SEC's Public Reference Room, 100 F St., NE, Washington DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from your submissions. You should submit only information that you wish to make available publicly.

Commodity Futures Trading Commission:

- Written comments may be mailed to the Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, DC 20581, attention Office of the Secretary; transmitted by facsimile to the CFTC at (202) 418-5521; or transmitted electronically to [Jointcommittee@cftc.gov](mailto:Jointcommittee@cftc.gov).

Reference should be made to "Joint CFTC-SEC Advisory Committee."

**FOR FURTHER INFORMATION CONTACT:** Ronesha Butler, Special Counsel, at (202) 551-5629, Division of Trading and Markets, or Elizabeth M. Murphy, Committee Management Officer, at (202) 551-5400, Securities and Exchange Commission, 100 F St., NE, Washington DC 20549, or Martin White, Committee Management Officer, at (202) 418-5129, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, DC 20581.

**SUPPLEMENTARY INFORMATION:** In accordance with Section 10(a) of the Federal Advisory Committee Act, 5 U.S.C. App. 1, § 10(a), James R. Burns and Timothy

Karpoff, each Co-Designated Federal Officer of the Committee, acting jointly, have approved publication of this notice.

By the Securities and Exchange Commission.

*Elizabeth M. Murphy*

Elizabeth M. Murphy  
Committee Management Officer

By the Commodity Futures Trading Commission.

Martin White  
Committee Management Officer

Dated: May 18, 2010

**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-62115; File No. 4-602]

**Market Structure Roundtable**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Notice of roundtable discussion; request for comment.

**SUMMARY:** The Securities and Exchange Commission will host a one day roundtable to solicit the views of investors, issuers, exchanges, alternative trading systems, financial services firms, high frequency traders, and the academic community regarding the current securities market structure. The roundtable will focus on market structure performance, including the events of May 6, metrics for evaluating market structure performance, high frequency trading, and undisplayed liquidity.

The roundtable discussion will be held in the auditorium of the Securities and Exchange Commission headquarters at 100 F Street, NE, in Washington, DC on June 2, 2010 from 9:30 a.m. to approximately 4:30 p.m. The public is invited to observe the roundtable discussion. Seating will be available on a first-come, first-served basis. The roundtable discussion also will be available via webcast on the Commission's Web site at [www.sec.gov](http://www.sec.gov).

The roundtable will consist of a series of panels. Panelists will consider a range of market structure topics, such as the appropriate metrics for assessing the performance and fairness of the market structure, particularly in light of the extraordinary price volatility of May 6. Panelists also will analyze the tools and strategies of high frequency trading and the role of undisplayed liquidity in today's market structure.

**DATES:** The roundtable discussion will take place on June 2, 2010. The Commission will accept comments regarding issues addressed at the roundtable until June 23, 2010.

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

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/other.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number 4-602 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 submission should refer to File Number 4-602. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov>). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Arisa Tinaves, Special Counsel, at (202) 551-5676 or Gary M. Rubin, Attorney, at (202) 551-5669, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

By the Commission.

Elizabeth M. Murphy  
Secretary

Dated: May 18, 2010

*Florence E. Harmon*  
By: Florence E. Harmon  
Deputy Secretary

**SECURITIES AND EXCHANGE COMMISSION**  
(Release No. 34-62120; File No. S7-04-09)

May 19, 2010

**ORDER GRANTING TEMPORARY CONDITIONAL EXEMPTION FOR NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS FROM REQUIREMENTS OF RULE 17g-5 UNDER THE SECURITIES EXCHANGE ACT OF 1934 AND REQUEST FOR COMMENT**

**I. Introduction**

The Securities and Exchange Commission ("Commission") is conditionally exempting, with respect to certain credit ratings and until December 2, 2010, nationally recognized statistical rating organizations ("NRSROs") from requirements in Rule 17g-5(a)(3)<sup>1</sup> under the Securities Exchange Act of 1934 ("Exchange Act") discussed below that have a compliance date of June 2, 2010.<sup>2</sup> Starting on that date, Rule 17g-5(a)(3) will apply when an issuer, sponsor, or underwriter (each an "arranger") hires an NRSRO to determine an initial credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction (a "structured finance product").<sup>3</sup> However, under this order, an NRSRO is not required to comply with Rule 17g-5(a)(3) until December 2, 2010 with respect to credit ratings where: (1) the issuer of the structured finance product is a non-U.S. person; and (2) the NRSRO has a reasonable basis to conclude that the structured finance product will be offered and sold upon issuance, and that any arranger linked to the structured finance product will effect transactions of the structured finance

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<sup>1</sup> 17 CFR 240.17g-5(a)(3).

<sup>2</sup> See Securities Exchange Act Release No. 61050 (Nov. 23, 2009), 74 FR 63832 (Dec. 4, 2009) ("Adopting Release").

<sup>3</sup> In the Adopting Release, the Commission stated that it intended the term "security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction," which mirrors, in part, the text of Section 15E(i)(1)(B) of the Exchange Act (15 U.S.C. 78o-7(i)(1)(B)), to cover the full range of structured finance products, including, but not limited to, securities collateralized by static and actively managed pools of loans or receivables (e.g., commercial and residential mortgages, corporate loans, auto loans, education loans, credit card receivables, and leases), collateralized debt obligations, collateralized loan obligations, collateralized mortgage obligations, structured investment vehicles, synthetic collateralized debt obligations that reference debt securities or indexes, and hybrid collateralized debt obligations.

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product after issuance, only in transactions that occur outside the U.S. The Commission also is soliciting comment regarding the application of Rule 17g-5(a)(3) to transactions outside of the U.S.

## II. Background

Rule 17g-5 identifies, in paragraphs (b) and (c) of the rule, a series of conflicts of interest arising from the business of determining credit ratings.<sup>4</sup> Paragraph (a) of Rule 17g-5<sup>5</sup> prohibits an NRSRO from issuing or maintaining a credit rating if it is subject to the conflicts of interest identified in paragraph (b) of Rule 17g-5 unless the NRSRO has taken the steps prescribed in paragraph (a)(1) (i.e., disclosed the type of conflict of interest in Exhibit 6 to Form NRSRO in accordance with Section 15E(a)(1)(B)(vi) of the Exchange Act<sup>6</sup> and Rule 17g-1)<sup>7</sup> and paragraph (a)(2) (i.e., established and is maintaining and enforcing written policies and procedures to address and manage conflicts of interest in accordance with Section 15E(h) of the Exchange Act).<sup>8</sup>

Paragraph (c) of Rule 17g-5 specifically prohibits outright seven types of conflicts of interest.

Consequently, an NRSRO is prohibited from issuing or maintaining a credit rating when subject to these conflict regardless of whether it had disclosed them and established procedures reasonably designed to address them.

In December 2009, the Commission adopted subparagraph (a)(3) of Rule 17g-5, which added new provisions to Rule 17g-5. These provisions require an NRSRO that is hired by an arranger to determine an initial credit rating for a structured finance product to take certain steps designed to allow an NRSRO that is not hired by the arranger to nonetheless determine an initial credit rating –

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<sup>4</sup> 17 CFR 240.17g-5(b) and (c).

<sup>5</sup> 17 CFR 240.17g-5(a).

<sup>6</sup> 15 U.S.C. 78o-7(a)(1)(B)(vi).

<sup>7</sup> 17 CFR 240.17g-1.

<sup>8</sup> 15 U.S.C. 78o-7(h).

and subsequently monitor that credit rating – for the structured finance product.<sup>9</sup> In particular, under Rule 17g-5(a)(3), an NRSRO is prohibited from issuing or maintaining a credit rating when it is subject to the conflict of interest identified in paragraph (b)(9) of Rule 17g-5 (*i.e.*, being hired by an arranger to determine a credit rating for a structured finance product)<sup>10</sup> unless it has taken the steps prescribed in paragraphs (a)(1) and (2) of Rule 17g-5 (discussed above) and the steps prescribed in new paragraph (a)(3) of Rule 17g-5.<sup>11</sup> Rule 17g-5(a)(3), among other things, requires that the NRSRO must:

- Maintain on a password-protected Internet Web site a list of each structured finance product for which it currently is in the process of determining an initial credit rating in chronological order and identifying the type of structured finance product, the name of the issuer, the date the rating process was initiated, and the Internet Web site address where the arranger represents the information provided to the hired NRSRO can be accessed by other NRSROs;
- Provide free and unlimited access to such password-protected Internet Web site during the applicable calendar year to any NRSRO that provides it with a copy of the certification described in paragraph (e) of Rule 17g-5 that covers that calendar year;<sup>12</sup> and

<sup>9</sup> See 17 CFR 240.17g-5(a)(3); *see also* Adopting Release at 63844-45.

<sup>10</sup> Paragraph (b)(9) Rule 17g-5 identifies the following conflict of interest: issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument. 17 CFR 240.17g-5(b)(9).

<sup>11</sup> 17 CFR 240.17g-5(a)(3).

<sup>12</sup> Paragraph (e) of Rule 17g-5 requires that an NRSRO seeking to access the hired NRSRO's Internet web site during the applicable calendar year must furnish the Commission with the following certification:

The undersigned hereby certifies that it will access the Internet Web sites described in 17 CFR §240.17g-5(a)(3) solely for the purpose of determining or monitoring credit ratings. Further, the undersigned certifies that it will keep the information it accesses pursuant to 17 CFR §240.17g-5(a)(3) confidential and treat it as material nonpublic information subject to its written policies and procedures established, maintained, and enforced pursuant to section 15E(g)(1) of the Act (15 U.S.C. 78o-7(g)(1)) and 17 CFR §240.17g-4. Further, the undersigned certifies that it will determine and maintain credit ratings for at least 10% of the issued securities and money market instruments for which it accesses information pursuant to 17 CFR §240.17g-5(a)(3)(iii), if it accesses such information for 10 or more issued securities or money market instruments in the calendar year covered by the certification. Further, the

- Obtain from the arranger a written representation that can reasonably be relied upon that the arranger will, among other things, disclose on a password-protected Internet web site the information it provides to the hired NRSRO to determine the initial credit rating (and monitor that credit rating) and provide access to the web site to an NRSRO that provides it with a copy of the certification described in paragraph (e) Rule 17g-5.<sup>13</sup>

The Commission stated in the Adopting Release that subparagraph Rule 17g-5(a)(3) is designed to address conflicts of interest and improve the quality of credit ratings for structured finance products by making it possible for more NRSROs to rate structured finance products.<sup>14</sup> For example, the Commission noted that when an NRSRO is hired to rate a structured finance product,

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undersigned certifies one of the following as applicable: (1) In the most recent calendar year during which it accessed information pursuant to §17 CFR 240.17g-5(a)(3), the undersigned accessed information for [Insert Number] issued securities and money market instruments through Internet Web sites described in 17 CFR §240.17g-5(a)(3) and determined and maintained credit ratings for [Insert Number] of such securities and money market instruments; or (2) The undersigned previously has not accessed information pursuant to 17 CFR §240.17g-5(a)(3) 10 or more times during the most recently ended calendar year.

<sup>13</sup> In particular, under paragraph (a)(3)(iii) of Rule 17g-5, the arranger must represent to the hired NRSRO that it will:

(1) Maintain the information described in paragraphs (a)(3)(iii)(C) and (a)(3)(iii)(D) of Rule 17g-5 available at an identified password-protected Internet Web site that presents the information in a manner indicating which information currently should be relied on to determine or monitor the credit rating;

(2) Provide access to such password-protected Internet Web site during the applicable calendar year to any NRSRO that provides it with a copy of the certification described in paragraph (e) of Rule 17g-5 that covers that calendar year, provided that such certification indicates that the nationally recognized statistical rating organization providing the certification either: (i) determined and maintained credit ratings for at least 10% of the issued securities and money market instruments for which it accessed information pursuant to paragraph (a)(3)(iii) of Rule 17g-5 in the calendar year prior to the year covered by the certification, if it accessed such information for 10 or more issued securities or money market instruments; or (ii) has not accessed information pursuant to paragraph (a)(3) of Rule 17g-5 10 or more times during the most recently ended calendar year.

(3) Post on such password-protected Internet Web site all information the arranger provides to the NRSRO, or contracts with a third party to provide to the NRSRO, for the purpose of determining the initial credit rating for the security or money market instrument, including information about the characteristics of the assets underlying or referenced by the security or money market instrument, and the legal structure of the security or money market instrument, at the same time such information is provided to the NRSRO; and

(4) Post on such password-protected Internet Web site all information the arranger provides to the NRSRO, or contracts with a third party to provide to the NRSRO, for the purpose of undertaking credit rating surveillance on the security or money market instrument, including information about the characteristics and performance of the assets underlying or referenced by the security or money market instrument at the same time such information is provided to the NRSRO.

<sup>14</sup> Adopting Release at 63844.

some of the information it relies on to determine the rating is generally not made public.<sup>15</sup> As a result, structured finance products frequently are issued with ratings from only the one or two NRSROs that have been hired by the arranger, with the attendant conflict of interest that creates.<sup>16</sup> Consequently, the Commission stated that subparagraph Rule 17g-5(a)(3) was designed to increase the number of credit ratings extant for a given structured finance product and, in particular, to promote the issuance of credit ratings by NRSROs that are not hired by the arranger.<sup>17</sup> The Commission's goal in adopting the rule was to provide users of credit ratings with more views on the creditworthiness of the structured finance product.<sup>18</sup> In addition, the Commission stated that Rule 17g-5(a)(3) was designed to reduce the ability of arrangers to obtain better than warranted ratings by exerting influence over NRSROs hired to determine credit ratings for structured finance products.<sup>19</sup> Specifically, by opening up the rating process to more NRSROs, the Commission intended to make it easier for the hired NRSRO to resist such pressure by increasing the likelihood that any steps taken to inappropriately favor the arranger could be exposed to the market through the credit ratings issued by other NRSROs.<sup>20</sup>

Rule 17g-5(a)(3) became effective on February 2, 2010, and the compliance date for Rule 17g-5(a)(3) is June 2, 2010.

### III. Basis for Relief

As discussed above, Rule 17g-5(a)(3) requires the hired NRSRO to obtain certain representations from an arranger in order to determine an initial credit rating for a structured finance

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<sup>15</sup> Id.

<sup>16</sup> Id.

<sup>17</sup> Id.

<sup>18</sup> Id.

<sup>19</sup> Id.

<sup>20</sup> Id.

product. Staff from the U.K. Financial Services Authority (“U.K. FSA”), the Japan Financial Services Authority (“Japan FSA”), Ontario Securities Commission (“OSC”) and the German Federal Financial Services Authority (“BaFin”) (collectively, the “Foreign Securities Regulators”), as well as a number of market participants,<sup>21</sup> have notified the Commission staff that arrangers of structured finance products located outside the U.S. generally were not aware that they would be required to make the representations prescribed in Rule 17g-5 in order to obtain credit ratings from NRSROs. These Foreign Securities Regulators and market participants have informed the Commission staff that many foreign arrangers are not prepared to make and adhere to the prescribed representations beginning on June 2, 2010 in terms of establishing the requisite Internet web sites, implementing other systems requirements necessary to make the disclosures and analyzing the application of local laws to their adherence to the disclosure requirements. Consequently, they have expressed concern that local securitization markets may be disrupted because the arrangers would not be able to make and adhere to the representations necessary to obtain credit ratings from NRSROs for new issuances of structured finance products. Foreign Securities Regulators and European issuers have also expressed concern about the potential conflict between the requirements of Rule 17g-5(a)(3) and European Union (“EU”) data protection and bank secrecy law and EU rating regulation, in addition to explaining that additional time is needed to identify other potential conflicts with EU and national laws.<sup>22</sup>

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<sup>21</sup> See letter dated March 30, 2010 from Richard Watson, Managing Director and Chief Operating Officer, Association for Financial Markets in Europe / European Securitisation Forum (AFME / ESF); letter dated April 30, 2010 from Christopher Killian, Vice President, Securitization Group of the Securities Industry and Financial Markets Association (SIFMA); letter dated April 30, 2010 from Neal Sullivan, Bingham McCutchen LLP on behalf of Rating and Investment Information, Inc.; letter dated May 3, 2010 from Tom Deutsch, Executive Director, American Securitization Forum; letter dated May 5, 2010 from Richard Watson, Managing Director and Chief Operating Officer, AFME / ESF; and letter dated May 12, 2010 from Guido Ravoet, European Banking Federation (“EBF Letter”). These letters, as well as other comments received by Commission staff in connection with subparagraph (a)(3) of Rule 17g-5 are available on the Commission’s Internet Web site, located at <http://www.sec.gov/comments/s7-04-09/s70409.shtml> and for web site viewing and printing in the Commission’s Public Reference Room in its Washington, DC headquarters.

<sup>22</sup> See, e.g., EBF Letter.

In the Adopting Release, the Commission noted that it was providing a delayed compliance date – 180 days after publication of certain rule amendments, including Rule 17g-5(a)(3), in the Federal Register – to allow NRSROs sufficient time to implement the new requirements.<sup>23</sup> Despite this delayed compliance date, overseas arrangers and market participants are not ready to comply with Rule 17g-5(a)(3), and Foreign Securities Regulators have expressed their respective belief that, absent relief, these arrangers and market participants will be unable to comply with Rule 17g-5(a)(3) with the result that overseas securitization markets may be disrupted. Section 36 of the Exchange Act authorizes the Commission to exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision of the Exchange Act or any rule thereunder to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors. Given the risk of serious disruptions to local securitization markets that have been described by Foreign Securities Regulators, the Commission believes that it is in the public interest, and consistent with the protection of investors, to delay the application of Rule 17g-5(a)(3) to certain overseas transactions and entities. Accordingly, the Commission is conditionally exempting, with respect to certain credit ratings and until December 2, 2010, NRSROs from requirements in Rule 17g-5(a)(3)<sup>24</sup> with respect to certain overseas transactions that are more fully described below.

#### **IV. Description of the Conditional Temporary Exemption**

The Commission is conditionally exempting NRSROs from Rule 17g-5(a)(3) until December 2, 2010 with respect to credit ratings where: (1) the issuer of the structured finance product is a non-U.S. person; and (2) the NRSRO has a reasonable basis to conclude that the structured finance product will be offered and sold upon issuance, and that any arranger linked to the structured finance

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<sup>23</sup> See Adopting Release at 63834.

<sup>24</sup> 17 CFR 240.17g-5(a)(3).



product will effect transactions in the structured finance product after issuance, only in transactions that occur outside the U.S. These conditions are designed to confine the exemption's application to credit ratings of structured finance products issued in, and linked to, financial markets outside the U.S.

The Commission notes that this exemption only applies to subparagraph (a)(3) of Rule 17g-5. It does not cover any other requirements in Rule 17g-5. Consequently, if an NRSRO determines a credit rating for a structured finance product that is exempt from Rule 17g-5(a)(3), the NRSRO remains subject to all the other prohibitions in Rule 17g-5.

**A. The issuer must be a non-U.S. person**

The first condition of the exemption is that the issuer of the structured finance product must be a non-U.S. person. The Commission understands that preparations for compliance with Rule 17g-5(a)(3) are lacking with respect to overseas issuers. This condition – that the issuer be a non-U.S. person -- is designed to provide the necessary relief for overseas issuers while circumscribing the relief to the scope of the problem that has been described to the Commission staff so that Rule 17g-5(a)(3) may go into effect to the extent possible. Further, the requirement is designed to suit the nature of the structured finance issuers. Many structured finance product issuers are bankruptcy remote special purpose vehicles. As such, they are primarily legal constructions as compared with operating companies that have employees, principal places of business, and physical locations. Consequently, rather than impose a condition that the issuer be located outside the U.S., the Commission is establishing a condition that the issuer be a non-U.S. person. To this end, and for the purposes of this order, the Commission intends a "U.S. person" to have the same definition as under Regulation S under the Securities Act.<sup>25</sup> Consequently, to satisfy this exemption, the NRSRO must be determining a credit rating for a structured finance product issued by a person that is not a U.S.

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<sup>25</sup> 17 CFR 230.902(k).

person.

**B. Transactions must be outside the U.S.**

The second condition of the exemption is that the NRSRO has a reasonable basis to conclude that the structured finance product will be offered and sold upon issuance, and that any arranger linked to the structured finance product will effect transactions of the structured finance product after issuance, only in transactions that occur outside the U.S. The Commission is confining the relief to only those transactions that occur outside the U.S. because it understands that it is with respect to overseas transactions that compliance preparations are lacking. Thus, circumscribing the relief to only those transactions that occur outside the U.S. will provide the necessary relief but still allow Rule 17g-5(a)(3) to come into effect where there are no such problems. An example of a transaction that occurs outside the U.S. would be a transaction that complies with the applicable safe harbor under Rules 903 and 904 of Regulation S.<sup>26</sup>

The question of whether an NRSRO has a “reasonable basis” to conclude that the structured finance product will be offered and sold upon issuance, and than any arranger linked to the structured finance product will effect transactions of the structured finance product after issuance, in transactions that occur outside the U.S. will depend on the facts and circumstances of a given situation. In order to have a reasonable basis to make these conclusions, the NRSRO should discuss with any arranger linked to the structured finance product (i.e., the sponsor, underwriter, and issuer) how they intend to market and sell the structured finance product and how they intend to engage in any secondary market activities (i.e., re-sales) of the structured finance product. An NRSRO may choose to obtain from the arranger a representation upon which the NRSRO can reasonably rely that sales of the structured finance product will meet this condition. Factors relevant to the analysis of whether such reliance would be reasonable would include, but not be limited to: (1) ongoing or prior

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<sup>26</sup> 17 CFR. 230.903; 17 CFR 230.904.

failures by the arranger to adhere to its representations; or (2) a pattern of conduct by the arranger where it fails to promptly correct breaches of its representations.

#### **V. Request for Comment**

The Commission notes that it intends to monitor the use of this temporary exemption to evaluate whether it is being used for transactions that meet the above-described conditions. If the Commission discovers that this temporary exemption is being used otherwise, it will consider whether further action is appropriate, including whether to revise or revoke the exemption. In this connection, the Commission requests comment on the following:

- With respect to foreign regulators, regulations, and laws, what specific conflicts, if any, will arise from the application of Rule 17g-5(a)(3)?
- Do any NRSROs, or credit rating agencies considering applying for registration as an NRSRO, intend to use information required to be provided on password-protected Internet Web sites by Rule 17g-5(a)(3) to determine and monitor credit ratings with respect to credit ratings that are being exempted from the requirements of Rule 17g-5(a)(3)? NRSROs or credit rating agencies that intend to use such information to determine and monitor credit ratings with respect to credit ratings that are being exempted are asked to provide specific details on when they expect to be ready to determine and monitor such credit ratings.
- What are the different types of structured finance and similar products used outside the U.S.? What factors should determine whether an instrument sold entirely or primarily outside of the U.S. is a structured finance product?
- What actions are NRSROs taking to prepare to comply with Rule 17g-5(a)(3)'s application to credit ratings that are being exempted by this order? What specific costs – compliance, operational, and any others -- will be associated with that compliance, including costs to arrangers?

Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/exorders.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-04-09 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 St., NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-04-09. 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/exorders.shtml>). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F St. NE., Washington, DC 20549 on official business days between the hours of 10 a.m. and 3 p.m. 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

## VI. Conclusion

For the foregoing reasons, the Commission believes it would be necessary or appropriate in the public interest and consistent with the protection of investors to grant a temporary exemption from the requirements in Rule 17g-5(a)(3) with respect to certain credit ratings.

ACCORDINGLY,

IT IS HEREBY ORDERED, pursuant to Section 36 of the Exchange Act, that a nationally recognized statistical rating organization is exempt until December 2, 2010 from the requirements in Rule 17g-5(a)(3) (17 CFR 240.17g-5(a)(3)) for credit ratings where:

(1) The issuer of the security or money market instrument is not a U.S. person (as defined under Securities Act Rule 902(k)); and

(2) The nationally recognized statistical rating organization has a reasonable basis to conclude that the structured finance product will be offered and sold upon issuance, and that any arranger linked to the structured finance product will effect transactions of the structured finance product after issuance, only in transactions that occur outside the U.S.

By the Commission.



Elizabeth M. Murphy  
Secretary

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 62136 / May 19, 2010

ACCOUNTING AND AUDITING ENFORCEMENT  
Release No. 3135 / May 19, 2010

ADMINISTRATIVE PROCEEDING  
File No. 3-13114

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In the Matter of :  
Michael G. Lutze, CPA : ORDER GRANTING APPLICATION FOR  
: REINSTATEMENT TO APPEAR AND PRACTICE  
: BEFORE THE COMMISSION AS AN ACCOUNTANT

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On August 5, 2008, Michael G. Lutze, CPA ("Lutze") was denied the privilege of appearing or practicing as an accountant before the Commission as a result of settled public administrative proceedings instituted by the Commission against Lutze pursuant to Rule 102(e) of the Commission's Rules of Practice.<sup>1</sup> Lutze consented to the entry of the August 5, 2008 order without admitting or denying the findings therein. This order is issued in response to Lutze's application for reinstatement to practice before the Commission as an accountant.

From April 2003 through May 2005, Lutze served as the coordinating partner on Ernst & Young LLP's ("E&Y") audits of the client at issue. The Commission alleged that on August 7, 2003, Lutze learned that a member of the client's Board of Directors and Audit Committee was serving as a paid advisor to E&Y at the National Industry level. Lutze took no follow-up action to learn the relationship's details or to assess its independence implications or to inform the client of the existence of the relationship. On May 4, 2004, E&Y informed the client of the relationship. On May 12, 2004, the client's Audit Committee asked Lutze to confirm in writing that neither he, nor the prior coordinating partner, nor anyone currently serving on the audit engagement was aware at any time prior to May 4, 2004 of the relationship. On May 14, 2004, Lutze furnished to the client's Audit Committee a letter on behalf of E&Y that failed to fully disclose the August 7, 2003 email that he had received. By failing to fully disclose the August 7, 2003 email that he had received, the Commission alleged that Lutze had engaged in improper

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<sup>1</sup> See Accounting and Auditing Enforcement Release No. 2858 dated August 5, 2008. Lutze was permitted, pursuant to the order, to apply for reinstatement after one year upon making certain showings.

professional conduct under Rule 102(e) of the Commission's Rule of Practice and Section 4C of the Securities Exchange Act of 1934.

Lutze has met all of the conditions set forth in the original order and, in his capacity as an independent accountant, has stated that he will comply with all requirements of the Commission and the Public Company Accounting Oversight Board, including, but not limited to all requirements relating to registration, inspections, concurring partner reviews and quality control standards. In his capacity as a preparer or reviewer, or as a person responsible for the preparation or review, of financial statements of a public company to be filed with the Commission, Lutze attests that he will undertake to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, while practicing before the Commission in this capacity.

Rule 102(e)(5) of the Commission's Rules of Practice governs applications for reinstatement, and provides that the Commission may reinstate the privilege to appear and practice before the Commission "for good cause shown."<sup>2</sup> This "good cause" determination is necessarily highly fact specific.

On the basis of the information supplied, representations made, and undertakings agreed to by Lutze, it appears that he has complied with the terms of the August 5, 2008 order denying him the privilege of appearing or practicing before the Commission as an accountant, that no information has come to the attention of the Commission relating to his character, integrity, professional conduct or qualifications to practice before the Commission that would be a basis for adverse action against him pursuant to Rule 102(e) of the Commission's Rules of Practice, and that Lutze, by undertaking to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, in his practice before the Commission as a preparer or reviewer of financial statements required to be filed with the Commission, and that Lutze, by undertaking to comply with all requirements of the Commission and the Public Company Accounting Oversight Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards, in his practice before the Commission as an independent accountant has shown good cause for reinstatement. Therefore, it is accordingly,

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<sup>2</sup> Rule 102(e)(5)(i) provides:

"An application for reinstatement of a person permanently suspended or disqualified under paragraph (e)(1) or (e)(3) of this section may be made at any time, and the applicant may, in the Commission's discretion, be afforded a hearing; however, the suspension or disqualification shall continue unless and until the applicant has been reinstated by the Commission for good cause shown." 17 C.F.R. § 201.102(e)(5)(i).

ORDERED pursuant to Rule 102(e)(5)(i) of the Commission's Rules of Practice that Michael G. Lutze, CPA is hereby reinstated to appear and practice before the Commission as an accountant.

By the Commission.

Elizabeth M. Murphy  
Secretary

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



*Commissioner Aquilar  
not participating*

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 62137 / May 19, 2010

ADMINISTRATIVE PROCEEDING  
File No. 3-13905

In the Matter of

ANGEL ROMO,

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 Angel Romo ("Romo" or the "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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### III.

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

1. Romo, age 43, is a resident of Montebello, California. Romo began working as a World Financial Group, Inc. associate in March 2004 and became a registered representative with World Group Securities, Inc., a broker/dealer registered with the Commission in November 2004. Romo has no prior disciplinary history with the Commission or any state or self-regulatory organization.

2. On April 21, 2010, a final judgment was entered by consent against Romo, permanently restraining and enjoining him from violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and from aiding and abetting future violations of Section 17(a) of the Exchange Act and Rules 17a-3(a)(6) and 17a-3(a)(17) thereunder in the civil action entitled Securities and Exchange Commission v. Ainsworth, et al., Civil Action Number EDCV08-1350 VAP (OPx), in the United States District Court for the Central District of California.

3. The Commission's complaint alleged that Romo's recommendation to a customer to purchase a Variable Universal Life insurance policy was unsuitable.

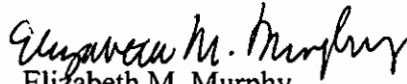
### IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Romo be, and hereby is suspended from association with any broker or dealer for a period of 90 days.

By the Commission.

  
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. 62144 / May 20, 2010

ADMINISTRATIVE PROCEEDING  
File No. 3-13906

In the Matter of

JESUS GUTIERREZ,

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 Jesus Gutierrez ("Gutierrez" or the "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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### III.

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

1. Gutierrez, age 38, is a resident of Downey, California. Gutierrez became a World Financial Group, Inc. associate in October 2003 and has been a registered representative with World Group Securities, Inc., a broker/dealer registered with the Commission, since September 2004. Gutierrez has no disciplinary history with the Commission or any state or self-regulatory organization.

2. On April 21, 2010, a final judgment was entered by consent against Gutierrez, permanently restraining and enjoining him from violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and from aiding and abetting future violations of Section 17(a) of the Exchange Act and Rules 17a-3(a)(6) and 17a-3(a)(17) thereunder in the civil action entitled Securities and Exchange Commission v. Ainsworth, et al., Civil Action Number EDCV08-1350 VAP (OPx), in the United States District Court for the Central District of California.

3. The Commission's complaint alleged that Gutierrez's recommendation to customers to purchase a Variable Universal Life insurance policy was unsuitable.

### IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Gutierrez be, and hereby is suspended from association with any broker or dealer for a period of 90 days.

By the Commission.

Elizabeth M. Murphy  
Secretary

  
By: Jill M. Peterson  
Assistant Secretary

*Commissioner Aguilar  
not participating*

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 62145 / May 20, 2010

ADMINISTRATIVE PROCEEDING  
File No. 3-13907

In the Matter of

KEDERIO AINSWORTH,

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 Kederio Ainsworth ("Ainsworth" or the "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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### III.

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

1. Ainsworth, age 41, is a resident of Rancho Cucamonga, California. Ainsworth became a World Financial Group, Inc. associate in June 2002 and a registered representative for World Group Securities, Inc., a broker/dealer registered with the Commission, in January 2003. Ainsworth resigned from WGS in April 2008. Ainsworth has no prior disciplinary history with the Commission or any state or self-regulatory organization.

2. On April 21, 2010, a final judgment was entered by consent against Ainsworth, permanently restraining and enjoining him from violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and from aiding and abetting future violations of Section 17(a) of the Exchange Act and Rules 17a-3(a)(6) and 17a-3(a)(17) thereunder in the civil action entitled Securities and Exchange Commission v. Ainsworth, et al., Civil Action Number EDCV08-1350 VAP (OPx), in the United States District Court for the Central District of California.

3. The Commission's complaint alleged that Ainsworth's recommendation to customers to purchase a Variable Universal Life insurance policy was unsuitable.

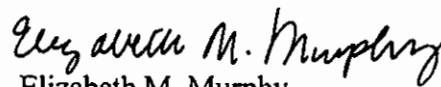
### IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Ainsworth be, and hereby is suspended from association with any broker or dealer for a period of 90 days.

By the Commission.

  
Elizabeth M. Murphy  
Secretary

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 62153 / May 21, 2010

ADMINISTRATIVE PROCEEDING

File No. 3-13911

In the Matter of

GENE T. MANCINELLI,

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 Gene T. Mancinelli ("Mancinelli" 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 and III.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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### III.

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

1. Mancinelli was a registered representative at Wall Street Access ("WSA"), a registered broker-dealer located in New York, from March 2001 to May 2002. Mancinelli was a Managing Director at WSA. WSA asked him to leave the firm after problems arose as a result of Mancinelli's executing late trades for one of his customers, Hedge Fund A. Mancinelli's customers included Hedge Fund A, as well as nearly all of WSA's market timing customers. Mancinelli also was in charge of WSA's fixed income municipal bond trading desk. Mancinelli, 49 years old, is a resident of New York, New York.

2. On May 3, 2010, an amended final judgment was entered by consent against Mancinelli, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and aiding and abetting violations of Sections 15(c) of the Exchange Act and Rule 10b-3 thereunder, in the civil action entitled Securities and Exchange Commission v. Gene T. Mancinelli, Civil Action Number 06-CV-7885, in the United States District Court for the Southern District of New York.

3. The Commission's complaint alleged that, in connection with the sale of mutual funds shares, Mancinelli and his customers defrauded mutual funds by engaging in late trading and by deceptively market timing mutual funds. From approximately April 2001 through October 2001, Mancinelli and others acting at his direction accepted and executed more than 2,000 late trades in mutual funds for a hedge fund customer, Hedge Fund A. Additionally, Mancinelli and his market timing customers utilized deceptive tactics to deceive mutual funds and facilitate these customers' market timing strategies. For example, Mancinelli opened multiple accounts for his market timing customers, and used multiple broker identification numbers to conceal his customers' identity from mutual funds that had previously identified these customers as market timers and blocked their trading. Mancinelli and WSA benefited from the late trading and market timing through, among other things, the fees Mancinelli's customers paid. At the same time, the mutual funds were harmed by the market timing and late trading of Mancinelli and his customers.

### IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, Respondent Mancinelli be, and hereby is barred from association with any broker or dealer with the right to reapply for association after three years to the appropriate self-regulatory organization, or if there is none, to the Commission.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of



factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

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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. 62162 / May 24, 2010**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-12631**

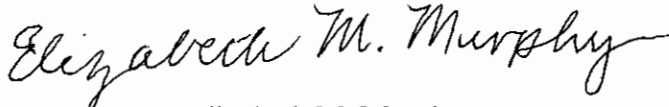
In the Matter of	)	
	)	
Morgan Stanley & Co.	)	<b>ORDER DIRECTING</b>
Incorporated,	)	<b>DISBURSEMENT OF</b>
	)	<b>DISGORGEMENT FUND</b>
Respondent.	)	
	)	

On June 23, 2009, the Commission published a plan of distribution ("Plan") and issued a Notice of the Proposed Plan of Disgorgement and Opportunity for Comment ("Notice") in connection with this proceeding (see Exchange Act Rel. No. 60160) pursuant to Rule 1103 of the Commission's Rules on Fair Funds and Disgorgement Plans, 17 C.F.R. 201.1103. No comments were received by the Commission in response to the Notice and on August 25, 2009, the Commission approved the Plan (see Exchange Act Rel. No. 60568).

The Plan provides that the Commission will arrange for distribution of the Disgorgement Fund when a validated payment file listing the payees with the identification information required to make a distribution has been received and accepted. The validated payment file has been received and accepted for the disbursement of \$2,891,887.33.

Accordingly, it is ORDERED that the Commission staff shall disburse the Disgorgement Fund in the amount stated in the validated payment file of \$2,891,887.33 as provided in the Plan.

By the Commission.

  
Elizabeth M. Murphy  
Secretary

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SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-62158; File No. SR-CBOE-2008-88)

May 24, 2010

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 Relating to the Demutualization of Chicago Board Options Exchange, Incorporated

**I. Introduction**

On August 21, 2008, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) a proposed rule change in connection with its plan to demutualize and restructure from a Delaware non-stock corporation to a Delaware stock corporation that would be a wholly-owned subsidiary of CBOE Holdings, Inc. (“CBOE Holdings”), a holding company organized as a Delaware stock corporation (the “Restructuring Transaction”).<sup>3</sup> To accommodate the Restructuring Transaction, CBOE proposed a Certificate of Incorporation and Bylaws for the newly formed CBOE Holdings, a new Certificate of Incorporation for CBOE, and to replace CBOE’s existing Constitution with new Bylaws. Finally, CBOE proposed amendments to its rules to address, among other things, trading access to the Exchange after the Restructuring Transaction. The proposed rule change was published for comment in the Federal Register on September 4, 2008.<sup>4</sup> The Commission received no comments on the proposal. On May 21, 2010, the Exchange filed

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> The term “Restructuring Transaction” is defined in proposed CBOE Rule 1.1(hhh) as “the restructuring of the Exchange from a non-stock corporation to a stock corporation and wholly-owned subsidiary of CBOE Holdings, Inc.”

<sup>4</sup> See Securities Exchange Act Release No. 58425 (August 26, 2008), 73 FR 51652 (“Notice”).

Amendment No. 1 to the proposal.<sup>5</sup> This order provides notice of filing of Amendment No. 1 and grants accelerated approval to the proposed rule change, as modified by Amendment No. 1.

## II. Discussion and Commission Findings

After careful review of the proposal, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>6</sup> In particular, as discussed in more detail below, the Commission finds that the proposed rule change is consistent with Section 6(b) of the Act.<sup>7</sup>

### A. The Restructuring Transaction

#### (1) Overview of the Proposed Corporate Structure

CBOE proposes to restructure from a Delaware non-stock corporation owned by its members to a Delaware stock corporation that would be a wholly-owned subsidiary of CBOE Holdings, a holding company organized as a Delaware stock corporation. As a result of the Restructuring Transaction, CBOE Holdings would become the sole stockholder of CBOE.<sup>8</sup> In

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<sup>5</sup> The substance of the proposed rule change and its filing with the Commission were approved by the Board of Directors of the Exchange prior to filing. At that time, the Exchange had not yet obtained approval from its members for the changes set forth in the proposal. On May 21, 2010, the Exchange obtained the requisite approval from its members. Amendment No. 1, among other things, reflects the membership's approval of this proposed rule change. See *infra* notes and text following note 172 for a discussion of Amendment No. 1 in greater detail.

<sup>6</sup> In approving the proposed rule change, the Commission has considered its impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>7</sup> 15 U.S.C. 78f.

<sup>8</sup> In Amendment No. 1, CBOE revised the proposed CBOE Holdings' Certificate of Incorporation to include the term "Regulated Securities Exchange Subsidiary" in the places that had referenced CBOE. A "Regulated Securities Exchange Subsidiary" is defined as "any national securities exchange, controlled, directly or indirectly, by CBOE Holdings, including, but not limited to CBOE." This change in terminology addresses CBOE's other national securities exchange C2 Options Exchange, Incorporated and would accommodate ownership of more than one national securities exchange by CBOE Holdings. See Amendment No. 1 at 4. See also Securities

addition, CBOE would transfer to CBOE Holdings all of the shares or interests CBOE currently owns in its subsidiaries, other than CBOE Stock Exchange, LLC, ("CBSX"), thereby making them wholly-owned subsidiaries of CBOE Holdings.<sup>9</sup> CBSX, which is an equity trading facility of CBOE, would remain a facility of CBOE in which CBOE would continue to hold a 50% interest.<sup>10</sup> CBOE would continue to be a self-regulatory organization ("SRO") and to operate its exchange business and facilities.

CBOE has proposed a new Certificate of Incorporation and Bylaws that are similar to the CBOE's current Certificate of Incorporation and Constitution, except that they reflect CBOE's proposed new structure. CBOE also has proposed to adopt a Certificate of Incorporation and Bylaws for CBOE Holdings that would address, among other things, the operation of the Exchange as an SRO in a holding company structure.<sup>11</sup> Finally, CBOE has proposed amendments to certain rules of the Exchange to reflect, among other things, the use of Trading Permits<sup>12</sup> to access the Exchange and its facilities.

(2) Conversion of Memberships

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Exchange Act Release No. 61152 (December 10, 2009), 74 FR 66699 (December 16, 2009) (order approving application of C2 Options Exchange, Incorporated).

<sup>9</sup> These subsidiaries are: CBOE Futures Exchange, LLC, which operates an electronic futures exchange; Chicago Options Exchange Building Corporation, which owns the building in which CBOE operates; CBOE, LLC, which holds a 24.01% interest in OneChicago, LLC, a security futures exchange; CBOE II, LLC, which has no assets or activities; DerivaTech Corporation, which owns certain educational software; Market Data Express, LLC, which distributes various types of market data; and The Options Exchange, Incorporated, which currently has no assets or activities.

<sup>10</sup> The remaining 50% interest in CBSX currently is owned by five registered broker-dealers.

<sup>11</sup> See *infra* note 51 and accompanying text (discussing CBOE's role in considering amendments to CBOE Holdings' corporate documents).

<sup>12</sup> See *infra* note 118 and accompanying text (describing Trading Permits).

After the Restructuring Transaction, the owners of membership interests in CBOE would become stockholders of CBOE Holdings through the conversion of their memberships into shares of common stock of CBOE Holdings. Each transferable CBOE membership existing on the date of the Restructuring Transaction would be converted into a certain number of shares of Class A common stock of CBOE Holdings.<sup>13</sup> The Class A common stock of CBOE Holdings would represent an equity ownership interest in CBOE Holdings, but would not provide its holders with physical or electronic access to CBOE and its trading facilities. In addition, Class B common stock of CBOE Holdings would be issued in the Restructuring Transaction in connection with the settlement of the litigation relating to the exercise right.

**B. CBOE Holdings**

After the Restructuring Transaction, CBOE Holdings would become the parent company and sole shareholder of CBOE. The proposed Certificate of Incorporation and Bylaws of CBOE Holdings would govern the activities of CBOE Holdings.

**(1) Governing Structure**

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<sup>13</sup> See Amendment No. 1 at 3. In the event of a future public offering by CBOE Holdings, each outstanding share of Class A common stock would be converted to one-half of one share of Class A-1 common stock and one-half share of one share of Class A-2 common stock, each of which would be subject to certain transfer restrictions. Specifically, Class A-1 common stock resulting from a conversion at the time of a public offering would be subject to a 180-day transfer restriction following the offering and Class A-2 common stock would be subject to a 360-day transfer restriction. Upon expiration of the restrictions, Class A-1 and Class A-2 common stock would convert to unrestricted common stock of CBOE Holdings. See *id.* Similarly, the Class B common stock of CBOE Holdings that will be issued in the Restructuring Transaction in connection with the settlement of the litigation relating to the exercise right would also be issued in a single class designated as Class B common stock. To ensure compliance with the transfer restrictions, Class A, Class A-1, Class A-2 and Class B common stock may only be recorded on the books and records of CBOE Holdings in the name of the owner of the shares. See *id.* CBOE Holdings would have the ability to issue preferred stock and unrestricted common stock including in connection with a with a public offering of shares of stock to investors who were not members of CBOE prior to the Restructuring Transaction and who would not be Trading Permit holders following the Restructuring Transaction. According to the Exchange, CBOE Holdings has no current intention to issue any shares of its preferred stock. See *id.*

CBOE Holdings Board of Directors. The CBOE Holdings Board of Directors (“CBOE Holdings Board”) would be composed of between 11 and 23 directors. Except with respect to the initial CBOE Holdings Board, the exact number would be established by the CBOE Holdings Board.<sup>14</sup> The initial CBOE Holdings Board would be composed of the 22 directors of CBOE immediately prior to the Restructuring Transaction.<sup>15</sup>

Except with respect to the initial CBOE Holdings Board, the Nominating and Governance Committee<sup>16</sup> would nominate candidates for the CBOE Holdings Board.<sup>17</sup> Each holder of CBOE Holdings voting stock would be entitled to one vote for each share of voting stock held, except as otherwise provided by the General Corporation Law of the State of Delaware or the Certificate of Incorporation or Bylaws of CBOE Holdings.<sup>18</sup>

The CBOE Holdings Board would be subject to a heightened independence requirement, with at least two-thirds of the directors satisfying the independence requirements adopted by the CBOE Holdings Board, as may be amended from time to time, which shall satisfy the independence requirements in the listing standards of the New York Stock Exchange (“NYSE”)

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<sup>14</sup> See proposed Article Seventh(b) of the CBOE Holdings Certificate of Incorporation and proposed Article 3.2 of the CBOE Holdings Bylaws.

<sup>15</sup> See Amendment No. 1 at 5-6 (concerning the size of the initial CBOE Holdings Board). CBOE currently has a 23-person Board with one vacancy that the CBOE Board does not intend to fill prior to the consummation of the Restructuring Transaction.

<sup>16</sup> See “Nominating and Governance Committee,” *infra* Section II.B.2. (describing composition of Nomination and Governance Committee).

<sup>17</sup> See proposed Article 2.11 of the CBOE Holdings Bylaws. Pursuant to proposed Article 2.11, the CBOE Holdings Board or a committee thereof each year would nominate candidates for the directors standing for election at the CBOE Holdings annual meeting of shareholders. See also Amendment No. 1 at 6-7 (discussing director nominees). In addition, subject to certain conditions, stockholders also have the right under this provision to nominate persons for the CBOE Holdings Board.

<sup>18</sup> See proposed Article 2.8 of the CBOE Holdings Bylaws. The Commission notes that there are no provisions in the proposed CBOE Holdings corporate documents providing for anything other than one vote for each share of voting stock held.

or The Nasdaq Stock Market.<sup>19</sup> CBOE Holdings directors would serve one-year terms.<sup>20</sup>

The CBOE Holdings Board would appoint one of its directors to serve as Chairman,<sup>21</sup> and may also appoint an independent director to serve as Lead Director, who would perform such duties and possess such powers as the CBOE Holdings Board may from time to time prescribe.<sup>22</sup>

Committees of CBOE Holdings. CBOE Holdings would have an Executive Committee, an Audit Committee, a Compensation Committee, a Nominating and Governance Committee, and such other committees that the CBOE Holdings Board establishes.<sup>23</sup> The members of each committee would be selected by the CBOE Holdings Board.

The Executive Committee would have all the powers and authority of the CBOE Holdings Board in the management of the business and affairs of CBOE Holdings, except it would not have the power or authority of the CBOE Holdings Board in reference to, among other things, amending the CBOE Holdings Certificate of Incorporation, adopting an agreement of merger or consolidation, approving the sale, lease or exchange of all or substantially all of the CBOE Holdings' property and assets, or approving the dissolution of CBOE Holdings or a

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<sup>19</sup> See Amendment No. 1 at 6. See proposed Article 3.3 of the CBOE Holdings Bylaws. See also Sections 303A.01 and 303A.02 of the NYSE's Listed Company Manual and Nasdaq Stock Market Rule 5605.

<sup>20</sup> See Amendment No. 1 at 6 (changing term duration from two-years, as initially proposed, to one-year).

<sup>21</sup> See proposed Article 3.6 of the CBOE Holdings Bylaws. The proposed CBOE Holdings Bylaws would not restrict the Chief Executive Officer of CBOE Holdings from serving in this role. See proposed Article 5.1 of the CBOE Holdings Bylaws.

<sup>22</sup> See proposed Article 3.7 of the CBOE Holdings Bylaws.

<sup>23</sup> See proposed Article 4.1 of the CBOE Holdings Bylaws. The CBOE Holdings Board would designate the members of these other committees and may designate a Chairman and a Vice-Chairman of each committee.



revocation of a dissolution.<sup>24</sup> The Executive Committee would include the Chairman of the Board (who would serve as the Chairman of the Executive Committee), the Chief Executive Officer (if a director), the Lead Director, if any, and such directors as the CBOE Holdings Board deems appropriate, provided that Executive Committee must at all times have a majority of independent directors.

The Nominating and Governance Committee would recommend members of CBOE Holdings' Executive, Audit, and Compensation Committees for approval by the CBOE Holdings Board.<sup>25</sup> The Nominating and Governance Committee would consist of at least five directors, all of whom would be Independent Directors.<sup>26</sup>

Officers of CBOE Holdings. CBOE Holdings would have a Chief Executive Officer, a Chief Financial Officer, a President, one or more Vice-Presidents (as determined by the CBOE Holdings Board); a Secretary, a Treasurer, and such other officers as the CBOE Holdings Board may determine, including an Assistant Secretary or Assistant Treasurer.<sup>27</sup> The Chief Executive Officer would have general charge and supervision of the business of CBOE Holdings.<sup>28</sup> Other officers would have the duties or powers or both set out in the CBOE Holdings Bylaws, as well

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<sup>24</sup> See proposed Article 4.2 of the CBOE Holdings Bylaws.

<sup>25</sup> See proposed Articles 4.2, 4.3 and 4.4 of the CBOE Holdings Bylaws.

<sup>26</sup> See Article 4.5 of the CBOE Holdings Bylaws. See also Amendment No. 1 at 6-7 (decreasing the size of the committee from seven to five). With the exception of the initial committee, all committee members would be recommended by the Nominating and Governance Committee for approval by the CBOE Holdings Board. See proposed Article 4.5 of the CBOE Holdings Bylaws. The initial Nominating and Governance Committee after the Restructuring Transaction would be selected by the CBOE Board or a committee thereof, consistent with the committee's composition requirements.

<sup>27</sup> See proposed Article 5.1 of the CBOE Holdings Bylaws.

<sup>28</sup> See proposed Articles 5.1 and 5.2 of the CBOE Holdings Bylaws.

as such other duties or powers or both as the CBOE Holdings Board or the Chief Executive Officer may from time to time prescribe.<sup>29</sup>

The Commission finds that the proposed provisions relating to the CBOE Holding Board are consistent with the Act, particularly Section 6(b)(1), which requires an exchange to be so organized and have the capacity to carry out the purposes of the Act.<sup>30</sup> In particular, these provisions will assist the Exchange in fulfilling its self-regulatory obligations and in administering and complying with the requirements of the Act.

(2) Ownership and Voting Restrictions

The proposed Certificate of Incorporation of CBOE Holdings places certain ownership and voting limits on the holders of CBOE Holdings stock and their Related Persons.<sup>31</sup> These restrictions are intended to address the possibility that a person holding a controlling interest in an entity that owns an SRO could use that interest to affect the SRO's regulatory responsibilities.<sup>32</sup>

Ownership Limitation. No person (either alone or together with its Related Persons) may beneficially own more than 10% of the total outstanding shares of CBOE Holdings stock. In the event of a public offering of common stock, the permissible ownership percentage threshold

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<sup>29</sup> See proposed Articles 5.3, 5.4, 5.5, 5.6 and 5.7 of the CBOE Holdings Bylaws.

<sup>30</sup> See Section 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1).

<sup>31</sup> The term "Related Person" is defined in proposed Article Fifth(a)(ix) of the CBOE Holdings Certificate of Incorporation and includes, among other things, persons associated with a Trading Permit Holder.

<sup>32</sup> The Commission notes that CBOE has received a legal opinion that the proposed ownership and voting limitations, as well as the provisions providing for the redemption of shares held by a person (either alone or together with its Related Persons) in excess of the ownership limitation, are valid under Delaware law. See Letter from Richards, Layton & Finger to CBOE Holdings, Inc. dated August 15, 2008.

would increase from 10% to 20%.<sup>33</sup> If a person, either alone or together with its Related Persons, exceeds these thresholds, such person and its Related Persons would be obligated to sell promptly, and CBOE Holdings would be obligated to redeem promptly, the number of shares of stock necessary so that such person, together with its Related Persons, would fall below the applicable threshold.<sup>34</sup>

Voting Limitation. No person (either alone or together with its Related Persons) would be entitled to vote or cause the voting of shares of stock beneficially owned by that person or those Related Persons to the extent that those shares would represent in the aggregate more than 10% of the total number of votes entitled to be cast on any matter. Further, no person (either alone or together with its Related Persons) would be entitled to vote more than 10% of the total number of votes entitled to be cast on any matter by virtue of agreements entered into by that person or those Related Persons with other persons not to vote shares of outstanding stock. In the event a public offering of common stock, these permissible voting percentage thresholds would increase from 10% to 20%.<sup>35</sup> Any attempted votes in the excess of such thresholds would be disregarded.<sup>36</sup>

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<sup>33</sup> See proposed Article Sixth(b) of the CBOE Holdings Certificate of Incorporation.

<sup>34</sup> See proposed Article Sixth(b) of the CBOE Holdings Certificate of Incorporation. CBOE Holdings would redeem such stock at a price equal to the par value of such shares of stock and to the extent that funds are legally available for such redemption. If shares of CBOE Holdings stock beneficially owned by any Person or its Related Persons are held of record by any other Person, this provision would be enforced against such record owner by requiring the redemption of shares of CBOE Holdings stock held by such record owner in a manner that would accomplish the ownership limitation applicable to such Person and its Related Persons. See id.

<sup>35</sup> See proposed Article Sixth(a) of the CBOE Holdings Certificate of Incorporation. The voting limitation does not apply to a solicitation of a revocable proxy by any CBOE Holdings stockholder on behalf of CBOE Holdings or by directors or officers of CBOE Holdings on behalf of CBOE Holdings or to a solicitation of a revocable proxy by a stockholder in accordance with Regulation 14A under the Act. 17 CFR 240.14A. This exception, however, would not apply to a solicitation by a stockholder pursuant to Rule 14a-2(b)(2) under the Act, which permits a

Waiver of Ownership or Voting Limitations. The CBOE Holdings Board may waive the ownership and voting limits and may impose conditions or restrictions by means of a resolution expressly permitting ownership or voting rights in excess of such limits, subject to a determination of the Board that.<sup>37</sup>

- the acquisition would not impair the ability of CBOE to discharge its responsibilities under the Act and the rules and regulations thereunder and is otherwise in the best interests of CBOE Holdings and its stockholders and CBOE;
- the acquisition would not impair the Commission's ability to enforce the Act;
- neither the person obtaining the waiver nor any of its Related Persons is subject to any statutory disqualification (as defined in Section 3(a)(39) of the Act);<sup>38</sup> and
- for so long as CBOE Holdings directly or indirectly controls CBOE, neither the person obtaining the waiver nor any of its Related Persons is a Trading Permit Holder.<sup>39</sup>

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solicitation made otherwise than on behalf of CBOE Holdings where the total number of persons solicited is not more than 10.

<sup>36</sup> See proposed Article Sixth(a) of the CBOE Holdings Certificate of Incorporation. If and to the extent that shares of CBOE Holdings stock beneficially owned by any person or its Related Persons are held of record by any other person, this provision would be enforced against such record owner by limiting the votes entitled to be cast by such record owner in a manner that would accomplish the voting limitation applicable to such person and its Related Persons.

<sup>37</sup> See proposed Articles Sixth(a) and (b) of the CBOE Holdings Certificate of Incorporation. Any such resolution must be filed with the Commission under Section 19 of the Act prior to becoming effective.

<sup>38</sup> 15 U.S.C. 78c(a)(39).

<sup>39</sup> A "Trading Permit Holder" is defined in Section 1.1(f) of the Bylaws of the Exchange as: any individual, corporation, partnership, limited liability company or other entity authorized by the Rules that holds a Trading Permit. If a Trading Permit Holder is an individual, the Trading Permit Holder may also be referred to an "individual Trading Permit Holder." If a Trading Permit Holder is not an individual, the Trading Permit Holder may also be referred to as a "TPH organization." A Trading Permit Holder is a "member" solely for purposes of the Act; however, one's status as a Trading Permit Holder does not confer on that Person any ownership interest in the Exchange.

The CBOE Holdings Board would have the right to require any person and its Related Persons that the Board reasonably believes to be subject to the voting or ownership restrictions summarized above to provide to CBOE Holdings complete information on all shares of CBOE Holdings stock that such stockholder beneficially owns, as well as any other information relating to the applicability to such stockholder of the voting and ownership requirements outlined above as may reasonably be requested.<sup>40</sup>

In addition, any changes to the CBOE Holdings Certificate of Incorporation, including any change in the provision that identifies CBOE Holdings as the sole owner of CBOE, must be filed with and approved by the Commission pursuant to Section 19 of the Act before it could become effective.<sup>41</sup> Further, pursuant to the Exchange's proposed Certificate of Incorporation, CBOE Holdings may not sell, transfer, or assign, in whole or in part, its ownership interest in CBOE. Any such purported action would trigger an amendment both to CBOE Holdings' and CBOE's governing documents, which in turn would be subject to consideration by the Commission pursuant to the rule filing procedure under Section 19 of the Act.

The Commission believes that these provisions are consistent with the Act. These requirements are designed to minimize the potential that a person could improperly interfere with or restrict the ability of the Commission or the Exchange to effectively carry out their regulatory oversight under the Act.

Members that trade on an exchange traditionally have had ownership interests in the exchange, particularly at mutually-held entities like CBOE.<sup>42</sup> However, as the Commission has

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<sup>40</sup> See proposed Article Sixth(d) of the CBOE Holdings Certificate of Incorporation.

<sup>41</sup> See 15 U.S.C. 78s.

<sup>42</sup> With the proposed demutualization of CBOE, all registered national securities exchanges will have converted to or been founded as non-mutually held entities.

noted in the past, a member's interest in an exchange or an entity that controls an exchange could become so large as to cast doubt on whether the exchange can fairly and objectively exercise its self-regulatory responsibilities with respect to that member.<sup>43</sup> A member that is a controlling shareholder of an exchange, or an entity that controls an exchange, might be tempted to exercise that controlling influence by directing the exchange to refrain from, or the exchange may hesitate to, diligently monitor and surveil the member's conduct or diligently enforce its rules and the federal securities laws with respect to conduct by the member that violates such provisions. The proposed ownership and voting limitations for persons with an equity interest in CBOE Holdings are designed to limit a person's ability to obtain and exercise such a controlling influence.

(3) Self-Regulatory Function and Oversight of CBOE

Although CBOE Holdings will not itself carry out regulatory functions, its activities with respect to the operation of CBOE must be consistent with, and not interfere with, the Exchange's self-regulatory obligations. The proposed CBOE Holdings Certificate of Incorporation contains various provisions designed to protect the independence of the self-regulatory function of CBOE, enable the Exchange 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, facilitate the ability of the Exchange and the Commission to fulfill their regulatory and oversight obligations under the Act.

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<sup>43</sup> See Securities Exchange Act Release Nos. 58375 (August 18, 2008), 73 FR 49498 (August 21, 2008) (File No. 10-182) (order approving application of BATS Exchange, Inc. for registration as an SRO); 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006) (SR-NYSE-2005-77) (order approving merger of New York Stock Exchange, Inc. and Archipelago, and demutualization of New York Stock Exchange, Inc.); 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131); 51149 (February 8, 2005), 70 FR 7531 (February 14, 2005) (SR-CHX-2004-26); 49718 (May 17, 2004), 69 FR 29611 (May 24, 2004) (SR-PCX-2004-08); 49098 (January 16, 2004), 69 FR 3974 (January 27, 2004) (SR-Phlx-2003-73); and 49067 (January 13, 2004), 69 FR 2761 (January 20, 2004) (SR-BSE-2003-19).

For example, the proposed CBOE Holdings Certificate of Incorporation contains a provision requiring each director of the CBOE Holdings Board to take into consideration the effect that CBOE Holdings' actions would have on CBOE's ability to carry out its responsibilities under the Act.<sup>44</sup> Similarly, for so long as CBOE Holdings controls CBOE, each officer, director, and employee of CBOE Holdings must give due regard to the preservation of the independence of the self-regulatory function of CBOE and to its obligations under the Act and such persons are prohibited from taking any actions that they reasonably should have known would interfere with the effectuation of any decisions by the Board of Directors of CBOE ("CBOE Board") relating to CBOE's regulatory functions, including disciplinary matters, or would adversely affect CBOE's ability to carry out its responsibilities under the Act.<sup>45</sup>

Further, the proposed CBOE Holdings Certificate of Incorporation provides that CBOE Holdings, its directors, officers, agents, and employees irrevocably submit to the jurisdiction of the U.S. federal courts, the Commission, and CBOE and CBOE Holdings, its directors, officers, agents, and employees, would waive any claims or defenses that they are not personally subject to the jurisdiction of the Commission, as well as any defenses relating to inconvenient forum, improper venue, or jurisdiction.<sup>46</sup> Further, so long as CBOE Holdings controls CBOE, the books, records, premises, officers, directors, and employees of CBOE Holdings would be deemed to be the books, records, premises, officers, directors, and employees of CBOE for purposes of and subject to oversight pursuant to the Act to the extent that they relate to CBOE.<sup>47</sup>

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<sup>44</sup> See proposed Article Sixteenth(d) of the CBOE Holdings Certificate of Incorporation.

<sup>45</sup> See proposed Article Sixteenth(c) of the CBOE Holdings Certificate of Incorporation.

<sup>46</sup> See proposed Article Fourteenth of the CBOE Holdings Certificate of Incorporation.

<sup>47</sup> The books and records of CBOE Holdings relating to the exchange business of CBOE would be subject at all times to inspection and copying by the Commission and CBOE. See *id.* In addition,

In addition, all confidential information pertaining to the self-regulatory function of CBOE (including but not limited to disciplinary matters, trading data, trading practices, and audit information) contained in the books and records of CBOE that comes into the possession of CBOE Holdings: (1) could not be made available to any persons other than to those officers, directors, employees and agents of CBOE Holdings that have a reasonable need to know the contents thereof; (2) would be retained in confidence by CBOE Holdings and the officers, directors, employees and agents of CBOE Holdings; and (3) could not be used for any commercial purposes.<sup>48</sup>

The proposed CBOE Holdings Certificate of Incorporation also requires CBOE Holdings to take reasonable steps to cause its directors, officers, and employees, prior to accepting such position with CBOE Holdings, to consent in writing to the applicability to them of Article Fourteenth, Article Fifteenth, and Sections (c) and (d) of Article Sixteenth of the CBOE Holdings Certificate of Incorporation, as applicable, with respect to their activities related to CBOE.<sup>49</sup> In addition, CBOE Holdings would take reasonable steps necessary to cause its agents, prior to accepting such a position with CBOE Holdings, to be subject to the same provisions, as applicable, with respect to their activities related to CBOE.<sup>50</sup>

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the CBOE Holdings Bylaws provide that the books of CBOE Holdings must be kept within the United States. See proposed Section 1.3 of the CBOE Holdings Bylaws.

<sup>48</sup> Notwithstanding this restriction, nothing in the CBOE Holdings Certificate of Incorporation would be interpreted so as to limit or impede the rights of the Commission or CBOE to access and examine such confidential information or to limit or impede the ability of any officers, directors, employees or agents of CBOE Holdings to disclose such confidential information to the Commission or CBOE. See proposed Article Fifteenth of the CBOE Holdings Certificate of Incorporation.

<sup>49</sup> See proposed Article Sixteenth(b) of the CBOE Holdings Certificate of Incorporation.

<sup>50</sup> See id.



In addition, for so long as CBOE Holdings controls CBOE, CBOE Holdings would be required to submit to the CBOE Board any proposed amendment to or repeal of any provision of the CBOE Holdings Certificate of Incorporation or CBOE Holdings Bylaws and to file such with the Commission before it may become effective.<sup>51</sup>

The Commission finds that the proposed governing documents for CBOE Holdings, discussed above, are designed to protect the independence of the self-regulatory function of CBOE and clarify the Commission's and CBOE's jurisdiction with respect to CBOE Holdings in a manner consistent with the Act. Accordingly, these provisions should help ensure CBOE Holdings' attention to the self-regulatory obligations of CBOE and facilitate the ability of CBOE to effectively carry out its regulatory responsibilities under the Act.

The Commission notes that under Section 20(a) of the Act,<sup>52</sup> any person with a controlling interest in CBOE would be jointly and severally liable with and to the same extent that CBOE is liable under any provision of the Act, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. In addition, Section 20(e) of the Act,<sup>53</sup> creates aiding and abetting liability for any person who knowingly provides substantial assistance to another person in violation of any provision of any provision of the Act or rule thereunder. Further, Section 21C of the Act<sup>54</sup> authorizes the Commission to enter a cease-and-desist order against any person who has been "a cause of" a violation of any provision of the Act through an act or omission that the person knew or should

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<sup>51</sup> See proposed Article Eleventh of the CBOE Holdings Certificate of Incorporation and proposed Article 10.2 of the CBOE Holdings Bylaws.

<sup>52</sup> 15 U.S.C. 78t(a).

<sup>53</sup> 15 U.S.C. 78t(e).

<sup>54</sup> 15 U.S.C. 78u-3.

have known would contribute to the violation. These provisions are applicable to CBOE Holdings' dealings with CBOE.

C. CBOE

Following the Restructuring Transaction, CBOE would become a Delaware for-profit stock corporation wholly-owned by CBOE Holdings. CBOE would issue a total of 1,000 shares of common stock, all of which would be owned by CBOE Holdings.<sup>55</sup> CBOE would continue to be registered as a national securities exchange under Section 6 of the Act and, accordingly, would continue to be an SRO responsible for enforcing compliance by its members (i.e., Trading Permit Holders) with the federal securities laws and with CBOE Rules.<sup>56</sup> Likewise, CBOE would continue as a participant and voting member in the following national market system plans: the Options Price Reporting Authority Plan, the Consolidated Tape Association, the Consolidated Quotation Plan, the Nasdaq Unlisted Trading Privileges Plan, the Options Order Protection and Locked/Crossed Market Plan, the Options Regulatory Surveillance Authority Plan, and the Options Listing Procedures Plan.<sup>57</sup>

CBOE's current Certificate of Incorporation, Constitution (which would be replaced by the proposed Bylaws), and selected rules are proposed to be amended to reflect, among other things, CBOE's status as wholly-owned subsidiary of CBOE Holdings.

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<sup>55</sup> Any sale, transfer or assignment by CBOE Holdings of any shares of CBOE common stock would require an amendment to the proposed CBOE Certificate of Incorporation and consequently would be subject to prior approval by the Commission pursuant to the rule filing procedure under Section 19 of the Act (15 U.S.C. 78s). See proposed Article Fourth of the CBOE Certificate of Incorporation.

<sup>56</sup> 15 U.S.C. 78f.

<sup>57</sup> These plans are joint industry plans entered into by SROs for the purpose of providing for, respectively, (i) last sale and quotation reporting in options and equities, (ii) intermarket options trading, (iii) the joint surveillance, investigation and detection of insider trading on the options exchanges, and (iv) the listing of standardized options.

(1) CBOE Board and Committees

The business and affairs of CBOE would continue to be managed under the direction of the CBOE Board. The CBOE Board would be composed of between 11 and 23 directors as fixed by the CBOE Board from time to time.<sup>58</sup> The initial CBOE Board would be composed of the 22 individuals who are the directors of CBOE immediately prior to the Restructuring Transaction.<sup>59</sup> Thus, the CBOE Board following the Restructuring Transaction would be composed of CBOE's Chief Executive Officer, twelve Non-Industry<sup>60</sup> Directors, and ten Industry<sup>61</sup> Directors.<sup>62</sup>

The number of Non-Industry Directors and Industry Directors may be increased from time to time by resolution of the CBOE Board, but the number of Industry Directors could not constitute less than 30% of the CBOE Board and in no event would the number of Non-Industry Directors constitute less than a majority of the CBOE Board.<sup>63</sup> In addition, at least 20% of the directors must be Industry Directors nominated (or otherwise selected through the petition process) by the Industry-Director Subcommittee (directors selected through this process are

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<sup>58</sup> See Amendment No. 1 at 7. See also proposed Article Fifth(b) of the CBOE Certificate of Incorporation and proposed Section 3.1 of the CBOE Bylaws.

<sup>59</sup> See Amendment No. 1 at 7.

<sup>60</sup> A "Non-Industry Director" would be defined as a person who is not an Industry Director. See proposed Section 3.1 of the CBOE Bylaws.

<sup>61</sup> See Notice, supra 4, 73 FR at 51658, n.58.

<sup>62</sup> See proposed Article Fifth(b) of the Amended and Restated Certificate of Incorporation and proposed Section 3.1 of the CBOE Bylaws. In comparison, the current CBOE Board has 23 directors, consisting of eleven public directors, eleven directors from the industry, and the Chairman of the Board (who is the CEO of CBOE). See Notice, supra note 4, 73 FR at 51658 (discussing the composition of the current CBOE Board).

<sup>63</sup> At all times, at least one Non-Industry Director would be a Non-Industry Director exclusive of the exceptions provided for in proposed Section 3.1 of the CBOE Bylaws and would have no material business relationship with a broker or dealer or the Exchange or any of its affiliates. See proposed Section 3.1 of the CBOE Bylaws.

referred to as "Representative Directors").<sup>64</sup> Directors would serve for one-year terms ending on the annual meeting following the meeting at which such directors were elected.<sup>65</sup>

The CBOE Board would appoint one of its directors to serve as Chairman, which could be the Chief Executive Officer of CBOE.<sup>66</sup> Each year following the annual election of the directors, the CBOE Board would select, from among the Industry Directors, a Vice Chairman of the CBOE Board to serve for a term of one year.<sup>67</sup> The CBOE Board also may appoint one of the Non-Industry Directors to serve as Lead Director, who would perform such duties and possess such powers as the CBOE Board may from time to time prescribe.<sup>68</sup>

## (2) Nomination and Election of Directors

Qualified individuals would be nominated for election to the CBOE Board by CBOE's Nominating and Governance Committee.<sup>69</sup> The committee would consist of at least seven

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<sup>64</sup> See proposed Section 3.1 of the CBOE Bylaws.

<sup>65</sup> See Amendment No. 1 at 9-10.

<sup>66</sup> See proposed Section 3.6 of the CBOE Bylaws. See also proposed Section 5.1(a) of the CBOE Bylaws (concerning the ability of the CEO to serve as Chairman of the CBOE Board).

<sup>67</sup> See proposed Section 3.7 of the CBOE Bylaws. The Vice Chairman would: (i) preside over the meetings of the CBOE Board in the event the Chairman of the Board is absent or unable to do so, (ii) serve as chair the Trading Advisory Committee, (iii) except as otherwise provided in the Rules or resolution of the CBOE Board, appoint, subject to the approval of the CBOE Board, the individuals to serve on all Trading Permit Holder committees established in the Rules or by resolution of the Board, and (iv) exercise such other powers and perform such other duties as are delegated to the Vice Chairman of the Board by the CBOE Board.

<sup>68</sup> See proposed Section 3.8 of the CBOE Bylaws. The CBOE Board currently has a Lead Director, and as provided in proposed Section 3.8 of the CBOE Bylaws, CBOE has the ability to continue the practice after the Restructuring Transaction.

<sup>69</sup> See *id.* In performing this function, the Nominating and Governance Committee would determine, subject to review by the Board, whether a director candidate satisfies the applicable qualifications for election as a director, and the decision of that committee shall, subject to review, if any, by the Board, be final. See proposed Section 3.1 of the CBOE Bylaws. CBOE anticipates that the Nominating and Governance Committee would use director questionnaires in connection with determining the qualifications of director candidates. See Notice, *supra* note 4, 73 FR at 51659, n.74.

directors, with a majority being Non-Industry Directors,<sup>70</sup> all of whom would be recommended by the then-serving Nominating and Governance Committee for approval by the Board. The initial Nominating and Governance Committee after the Restructuring Transaction would be selected by the CBOE Board or a committee thereof, consistent with the applicable proposed compositional requirements.<sup>71</sup>

Industry-Director Subcommittee. The Industry-Director Subcommittee of the Nominating and Governance Committee, composed of all of the Industry Directors then serving on the Nominating and Governance Committee, would be responsible for recommending a number of Representative Directors that equals 20% of the total number of directors serving on the CBOE Board.<sup>72</sup> The subcommittee would provide a mechanism for Trading Permits Holders to provide input with respect to nominees for the Representative Directors. The subcommittee would also issue a circular to Trading Permit Holders identifying the Representative Director nominees.<sup>73</sup>

The proposed Nominating and Governance Committee would be bound to accept and nominate the Representative Directors recommended by the Industry-Director Subcommittee, provided that the Representative Directors so nominated by the Industry-Director Subcommittee

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<sup>70</sup> See proposed Section 4.5 of the CBOE Bylaws.

<sup>71</sup> The composition of the proposed new Nominating and Governance Committee differs from the composition of CBOE's current Nominating Committee in that the current Nominating Committee consists of a majority of "industry" members and is not tasked with responsibility for governance issues. In addition, the current Nominating Committee is not a committee of the current CBOE Board, but rather is a separate committee elected by the voting members of the Exchange. See Section 4.1 of the current CBOE Constitution.

<sup>72</sup> See proposed Section 3.2 of the CBOE Bylaws. If 20% of the directors then serving on the CBOE Board is not a whole number, such number of Representative Directors would be rounded up to the next whole number. See proposed Section 3.2 of the CBOE Bylaws. Industry Directors not selected by the Industry-Director Subcommittee would be selected by the Nominating and Governance Committee. See proposed Section 3.2 of the CBOE Bylaws.

<sup>73</sup> See id.

are not opposed by a petition candidate. If such Representative Directors are opposed by a petition candidate, then the Nominating and Governance Committee would be bound to accept and nominate the Representative Directors who receive the most votes pursuant to a "Run-off Election," as described below.<sup>74</sup>

Petition Process. Trading Permit Holders may nominate alternative candidates for election to the Representative Director positions by submitting a petition signed by individuals representing not less than 10% of the total outstanding Trading Permits at that time. If one or more valid petitions are received, a Run-off Election would be held. In any Run-off Election, each Trading Permit Holder would have one vote for each Representative Director position; provided, however, that no Trading Permit Holder, either alone or together with its affiliates, may account for more than 20% of the votes cast for a candidate. Any votes cast by a Trading Permit Holder, either alone or together with its affiliates, in excess of this 20% limitation would be disregarded.<sup>75</sup>

The winner(s) of the Run-off Election would be nominated as the Representative Director(s) by the Nominating and Governance Committee for that year. In addition, CBOE and CBOE Holdings have entered into a Voting Agreement pursuant to which CBOE Holdings has committed to vote in favor of the Representative Directors recommended by the Nominating and Governance Committee.<sup>76</sup>

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<sup>74</sup> See id.

<sup>75</sup> See proposed Section 3.1 of the CBOE Bylaws. In any Run-off Election, Trading Permits representing one-third of the total outstanding Trading Permits entitled to vote, when present in person or represented by proxy, would constitute a quorum for purposes of the Run-off Election. See id.

<sup>76</sup> CBOE included the proposed Voting Agreement as Exhibit 5F to its proposed rule change.

The Commission believes that the requirements in the proposed CBOE Bylaws that 20% of the CBOE Board be Representative Directors and the means by which they are chosen by members provides for the fair representation of members in the selection of directors and the administration of the Exchange consistent with the requirements of Section 6(b)(3) of the Act.<sup>77</sup> As the Commission has previously noted, this requirement helps to ensure that members have a voice in the use of the SRO's self-regulatory authority, and that an exchange is administered in a way that is equitable to all those who trade on its market or through its facilities.<sup>78</sup>

The Commission has previously stated its belief that the inclusion of public, non-industry representatives on exchange oversight bodies is critical to an exchange's ability to protect the public interest.<sup>79</sup> Further, public non-industry representatives help to ensure that no single group of market participants has the ability to disadvantage other market participants through the exchange governance process. The Commission believes that public directors can provide unique, unbiased perspectives, which should enhance the ability of the CBOE Board to address issues in a non-discriminatory fashion and foster the integrity of the Exchange.<sup>80</sup> The Commission also believes that the proposed CBOE Board satisfies the requirements in Section 6(b)(3) of the Act,<sup>81</sup> 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. In

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<sup>77</sup> 15 U.S.C. 78f(b)(3).

<sup>78</sup> See, e.g., Securities Exchange Act Release Nos. 58375 (August 18, 2008), 73 FR 49498 (August 21, 2008) (File No. 10-182) ("BATS Exchange Registration Order"); 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131) ("Nasdaq Exchange Registration Order").

<sup>79</sup> See, e.g., Regulation of Exchanges and Alternative Trading Systems, Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Release").

<sup>80</sup> See, e.g., BATS Exchange Registration Order and Nasdaq Exchange Registration Order, supra note 78, 73 FR at 49501 and 71 FR at 3553, respectively.

<sup>81</sup> 15 U.S.C. 78f(b)(3).

particular, at least one Non-Industry Director would be a Non-Industry Director exclusive of any exceptions and would have no material business relationship with a broker or dealer or the Exchange or any of its affiliates.

(3) Committees of CBOE

In addition to the Nominating and Governance Committee discussed above, CBOE would have an Executive Committee, an Audit Committee, a Compensation Committee, a Regulatory Oversight Committee, and such other standing and special committees as may be approved by the CBOE Board. Except as may be otherwise provided in the CBOE Bylaws, the Board would have the authority to remove committee members.<sup>82</sup>

Director Committees. Director candidates for CBOE's Executive, Audit, and Compensation Committees would be recommended by the Nominating and Governance Committee for approval by the CBOE Board.<sup>83</sup> The Audit Committee and the Compensation Committee would each consist of at least three directors, all of whom would be Non-Industry Directors.<sup>84</sup> The Regulatory Oversight Committee, which would be charged with overseeing the independence and integrity of the regulatory functions of the Exchange, would consist of at least three directors,<sup>85</sup> all of whom would be Non-Industry Directors recommended by the Non-Industry Directors on the Nominating and Governance Committee for approval by the Board.<sup>86</sup>

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<sup>82</sup> See proposed Section 4.1(a) of the CBOE Bylaws.

<sup>83</sup> See proposed Sections 4.2, 4.3 and 4.4 of the CBOE Bylaws. The selection and composition of the Nominating and Governance Committee is discussed above.

<sup>84</sup> See proposed Section 4.3 of the CBOE Bylaws (Audit Committee) and Section 4.4 of the CBOE Bylaws (Compensation Committee).

<sup>85</sup> See Amendment No. 1 at 11 (changing the number of directors required from four to three to allow for greater flexibility in the designation of the committee).

<sup>86</sup> See proposed Section 4.6 of the CBOE Bylaws.



The Executive Committee<sup>87</sup> would consist of the Chairman and Vice Chairman of the CBOE Board, the Chief Executive Officer (if a director), the Lead Director (if any), at least one Representative Director, and such other number of directors that the Board deems appropriate, provided that at all times the majority of the directors serving on the Executive Committee are Non-Industry Directors.<sup>88</sup>

Member Committees. In addition to these CBOE Board-level committees, CBOE would have certain Exchange-level committees, including a Trading Advisory Committee and such other committees as may be provided from time to time.<sup>89</sup> The proposed Trading Advisory Committee would advise the Office of the Chairman regarding matters of interest to Trading

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<sup>87</sup> CBOE noted that its current Executive Committee (as well as the proposed new Executive Committee) generally does not make a decision unless there is a need for a CBOE Board-level decision between CBOE Board meetings due to the time sensitivity of the matter. See Notice, supra note 4, 73 FR at 51660-61. In addition, in situations when the current Executive Committee does make a decision between CBOE Board meetings, CBOE noted that the CBOE Board is generally aware ahead of time of the potential that the Executive Committee may need to make the decision. See id. CBOE notes that the current CBOE Board is, and after the Restructuring Transaction would continue to be, fully informed of any decision made by the current (and new) Executive Committee at its next meeting and can always decide to review that decision and take different action. See id.

<sup>88</sup> See proposed Section 4.2 of the CBOE Bylaws. If the Vice Chairman is a Representative Director, the requirement to have at least one Representative Director on the new Executive Committee would be satisfied by the Vice Chairman's participation on that committee. The Executive Committee would have all the powers and authority of the CBOE Board in the management of the business and affairs of CBOE, except it would not have the power and authority of the Board to, among others: (i) approve or adopt or recommend to the stockholders any action or matter (other than the election or removal of directors) expressly required by Delaware law to be submitted to stockholders for approval, including without limitation, amending the proposed CBOE Certificate of Incorporation, adopting an agreement of merger or consolidation, approving a sale, lease or exchange of all or substantially all of CBOE's property and assets, or approval of a dissolution of CBOE or revocation of a dissolution, or (ii) adopt, alter, amend or repeal any bylaw of CBOE. See proposed Section 4.2 of the CBOE Bylaws.

<sup>89</sup> See proposed Section 4.1(b) of the CBOE Bylaws. "Exchange committees" refers to committees that are not solely composed of directors from the CBOE Board. Except as may be otherwise provided in the CBOE Bylaws, the rules or the resolution of the CBOE Board establishing any such other committee, the Vice Chairman of the Board, with the approval of the CBOE Board, would appoint the members of such Exchange committees (other than the committees of the CBOE Board) and may designate, with the approval of the Board, a Chairman and a Vice-Chairman thereof.

Permit Holders.<sup>90</sup> The majority of the committee would be individuals involved in trading either directly or through their firms. The Vice Chairman would serve as the Chairman of the committee and would appoint, with the approval of the CBOE Board, the other members of the committee. The proposed Trading Advisory Committee would serve as the replacement for CBOE's current Floor Directors Committee, which advises CBOE regarding trading and floor-related issues.

In addition, CBOE would continue to maintain a Business Conduct Committee ("BCC"), which would remain involved with the hearing of disciplinary matters.<sup>91</sup> CBOE is not proposing any material changes to the structure or function of the BCC.<sup>92</sup>

The Commission believes that the compositional requirements with respect to the committees discussed above are designed to ensure that members are protected from unfair, unfettered actions by the Exchange pursuant to its rules, and that, in general, the Exchange is administered in a way that is equitable to all those who trade on its market or through its facilities. The Commission believes that the proposed compositional balance of these CBOE committees is consistent with the Section 6(b)(3) of the Act, because it provides for the fair representation of Trading Permit Holders in the administration of the affairs of CBOE.

(4) Filling of Vacancies and Removal for Cause

Any vacancy in the CBOE Board could be filled by vote of a majority of the directors then in office or by a sole remaining director, provided such new director qualifies for the

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<sup>90</sup> See proposed Section 4.7 of the CBOE Bylaws.

<sup>91</sup> See CBOE Rule 2.1(a). See also *infra* II.D (discussing the BCC).

<sup>92</sup> See Notice, *supra* note 4, 73 FR at 51663.

category in which the vacancy exists.<sup>93</sup> In the event the CBOE Board needs to fill a vacancy in a Representative Director position, the Industry-Director Subcommittee of the Nominating and Governance Committee would either (i) recommend an individual to the CBOE Board to be elected to fill such vacancy or (ii) provide a list of recommended individuals to the CBOE Board from which the Board shall elect the individual to fill such vacancy.<sup>94</sup> In addition, the proposed CBOE Bylaws provide that no Representative Director may be removed from office at any time except for cause.<sup>95</sup>

(5) Officers of CBOE

CBOE would have a Chief Executive Officer, a Vice Chairman, a President, a Chief Financial Officer, one or more Vice-Presidents, a Secretary, a Treasurer, and such other officers as the CBOE Board may determine, including an Assistant Secretary and Assistant Treasurer.<sup>96</sup> In general, the officers would have the duties and powers set forth in the CBOE Bylaws, as well as such other duties or powers or both as the CBOE Board or, as applicable, the Chief Executive Officer may from time to time prescribe.<sup>97</sup>

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<sup>93</sup> See proposed Section 3.5(a) of the CBOE Bylaws.

<sup>94</sup> See proposed Section 3.5(b) of the CBOE Bylaws. Any individual recommended by the Industry-Director Subcommittee to fill the vacancy of a Representative Director position must qualify as an Industry Director.

<sup>95</sup> See proposed Section 3.4(c) of the CBOE Bylaws.

<sup>96</sup> See proposed Section 5.1(a) of the CBOE Bylaws.

<sup>97</sup> See proposed Sections 5.3, 5.4, 5.5, 5.6, 5.7 and 5.8 of the CBOE Bylaws. A few notable differences concerning CBOE's officers following the Restructuring Transaction include the following: (1) the Chief Executive Officer may, but would not have to, be a director or the Chairman of the CBOE Board; (2) the CBOE Board, as opposed to the membership, would select the Vice Chairman; and (3) the position of Chief Financial Officer would be formally incorporated into the CBOE Bylaws.

Contrary to the current CBOE Constitution,<sup>98</sup> the proposed CBOE Bylaws would not restrict an officer from being a Trading Permit Holder or a person associated with a Trading Permit Holder or a broker or a dealer in securities or commodities or an associated person of such broker or dealer. The Exchange notes that there are other protections in place that limit the potential conflicts between the Exchange as an SRO and Trading Permit Holders, including, among other things, the existence of a Regulatory Oversight Committee as a committee of the Board that consists solely of Non-Industry Directors.<sup>99</sup>

The Commission finds that this proposed change consistent with the Act, including Section 6(b)(2) of the Act,<sup>100</sup> which requires that a national securities exchange have rules that provide that any registered broker or dealer may become a member. The Commission finds that there are sufficient safeguards in place to limit potential conflicts of interest between the Exchange as an SRO and Trading Permit Holders.

(6) Self-Regulatory Function and Oversight

As noted above, following the Restructuring Transaction, CBOE would continue to be registered as a national securities exchange under Section 6 of the Act and thus would continue to be an SRO.<sup>101</sup> As an SRO, CBOE is obligated to carry out its statutory responsibilities, including enforcing compliance by Trading Permit Holders with the provisions of the federal securities laws and the rules of CBOE. In addition, CBOE would continue to be required to file

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<sup>98</sup> See Section 8.1(b) of the current CBOE Constitution.

<sup>99</sup> See Notice, *supra* note 4, 73 FR at 51662.

<sup>100</sup> 15 U.S.C. 78f(b)(2).

<sup>101</sup> 15 U.S.C. 78f.

with the Commission, pursuant to Section 19(b) of the Act<sup>102</sup> and Rule 19b-4 thereunder,<sup>103</sup> any proposed changes to its rules and governing documents.

The proposed CBOE Certificate of Incorporation contains various provisions designed to protect the self-regulatory functions of CBOE in light of the proposed new corporate structure. For example, each director would be required to take into consideration the effect that his or her actions would have on CBOE's ability to carry out its responsibilities under the Act.<sup>104</sup> The proposed CBOE Certificate of Incorporation also includes provisions designed to protect confidential information pertaining to the self-regulatory function of the Exchange.<sup>105</sup>

In addition, proposed CBOE Rule 2.51 requires that any revenue CBOE receives from regulatory fees or penalties would only be applied to fund the legal, regulatory, and surveillance operations of the Exchange and would not be used to pay dividends to CBOE Holdings, except in the event of liquidation of CBOE, in which case CBOE Holdings would be entitled to the distribution of CBOE's remaining assets.<sup>106</sup>

The Commission believes that the Exchange's proposed provisions concerning the self-regulatory function of CBOE 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.<sup>107</sup> In particular, CBOE's proposed governing documents are designed to assist the

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<sup>102</sup> 15 U.S.C. 78s(b).

<sup>103</sup> 17 CFR 240.19b-4.

<sup>104</sup> See proposed Article Fifth(d) of the CBOE Certificate of Incorporation.

<sup>105</sup> See proposed Article Eleventh of the CBOE Certificate of Incorporation.

<sup>106</sup> See Notice, supra note 4, 73 FR at 51662, and Amendment No. 1 at 14 (codifying this provision in proposed Rule 2.51).

<sup>107</sup> See 15 U.S.C. 78f(b)(1).

Exchange in fulfilling its self-regulatory obligations and in administering and complying with the requirements of the Act.

(7) Paragraph (b) of Article Fifth of the CBOE Certificate of Incorporation

While the content of the Exchange's new Certificate of Incorporation and Bylaws would be similar to the content of the Exchange's old Certificate of Incorporation and Constitution, the new Certificate of Incorporation would not include, among other things, paragraph (b) of Article Fifth of the current CBOE Certificate of Incorporation ("Article Fifth(b)").<sup>108</sup> Article Fifth(b) provides the right for full members of The Board of Trade of the City of Chicago, Inc. ("CBOT") to become members of CBOE without having separately to purchase or lease a membership.<sup>109</sup>

Article Fifth(b) further provides that no amendment may be made to it without the prior approval of not less than 80% of both (i) the regular members of the Exchange admitted pursuant to Article Fifth(b) and (ii) the regular members of the Exchange admitted other than pursuant to Article Fifth(b), with each category voting as a separate class. CBOE has received a legal opinion from its Delaware counsel that under Delaware law, because the Restructuring Transaction is structured as a merger, this provision of Article Fifth(b) would not be triggered

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<sup>108</sup> As a result of this change, the Exchange is proposing to delete CBOE Rule 3.16, which addresses certain issues related to Article Fifth(b).

<sup>109</sup> On January 15, 2008, the Commission approved an interpretation of Article Fifth(b) ("Article Fifth(b) Interpretation") that addressed the impact of the acquisition of CBOT by Chicago Mercantile Exchange Holdings Inc. ("CME/CBOT Transaction") on the eligibility of persons to become or remain members of CBOE ("exerciser members") pursuant to Article Fifth(b) (the right provided under this provision is sometimes referred to as the "exercise right"). See Securities Exchange Act Release No. 57159 (January 15, 2008), 73 FR 3769 (January 22, 2008) (order approving File No. SR-CBOE-2006-106). Under that interpretation, the consummation of the CME/CBOT Transaction resulted in no person any longer qualifying as a member of the CBOT within the meaning of Article Fifth(b) and therefore resulted in the elimination of any person's eligibility to qualify thereafter to become or remain an exerciser member of the Exchange.

and the demutualization and related amendments to the Exchange's governing documents could be effected through a simple majority vote of members.<sup>110</sup>

In approving this proposal, the Commission is relying on CBOE's representation that its approach is appropriate under Delaware state law. The Commission is also relying on CBOE's letter of counsel that concludes that the Restructuring Transaction constitutes a merger and thus does not require the 80% vote contemplated in Article Fifth(b). Without opining on the merits of any claims arising solely under state law, the Commission finds that CBOE has articulated a sufficient basis to support its proposed changes.

**D. Disciplinary Matters and Trading and Disciplinary Rule Changes**

An 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.<sup>111</sup>

CBOE's current process for the hearing of disciplinary matters, and the rules governing that process, would remain substantively unchanged after the Restructuring Transaction. Under CBOE Rule 17.6(a), the hearing of a disciplinary matter currently is conducted by one or more members of the BCC. It has been the BCC's general practice to use three-person BCC hearing panels that include both industry and public representation, and CBOE is not proposing to change this process following demutualization.<sup>112</sup> Consistent with CBOE Rule 17.9, any decision of a BCC hearing panel that is not composed of at least a majority of the BCC is reviewed by the full BCC.

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<sup>110</sup> See Letter from Richards, Layton & Finger to Chicago Board Options Exchange, Incorporated dated August 20, 2008.

<sup>111</sup> See 15 U.S.C.78f(b)(1).

<sup>112</sup> See Notice, supra note 4, 73 FR at 51661.

In addition, the current process for the review of appeals of disciplinary actions, and the rules governing that process, would remain substantively unchanged. Under current Rule 17.10(b), the CBOE Board is vested with the authority to review appeals of disciplinary actions. The CBOE Board may appoint a committee of the Board composed of at least 3 directors to review the appeal, but the decision of that committee must be ratified by the CBOE Board. Thus, after the Restructuring Transaction, Trading Permit Holders would have a say in the review of such appeals through their representation on the CBOE Board.<sup>113</sup>

The current process for the review of proposed trading and disciplinary rules also would remain unchanged. Since the CBOE Board would continue to be responsible for approving rule changes, including changes to trading and disciplinary rules,<sup>114</sup> Trading Permit Holders would have a voice in the review of these rules through their representation on the CBOE Board. In addition, the proposed Trading Advisory Committee, which would replace the existing Floor Directors Committee, would assume that prior committee's responsibility for the review of many of CBOE's proposed rule changes (particularly trading rules) in an advisory capacity. Accordingly, the Trading Advisory Committee would provide a mechanism for Trading Permit Holders to provide input on trading rules.

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<sup>113</sup> As CBOE previously noted, it has been the CBOE Board's general practice to appoint a cross-section of directors to the CBOE Board committees that review appeals of disciplinary actions. See Notice, supra note 4, 73 FR at 51662. These committees usually consist of a floor or at-large director, an off-floor director, and a public director. See id. CBOE is not proposing to change this general practice and would expect that CBOE Board committees that review disciplinary decision appeals after the Restructuring Transaction would generally consist of an Industry Director who or whose firm is engaged in trading on the Exchange, an Industry Director whose firm is significantly engaged in conducting a securities business with public customers, and a Non-Industry Director. See id.

<sup>114</sup> See proposed Section 10.1 of the CBOE Bylaws.



The Commission finds that the Exchange's amended By-Laws and rules concerning its disciplinary and oversight programs are consistent with the Act, including the requirements of Sections 6(b)(6)<sup>115</sup> of the Act, which requires the rules of an exchange to provide for the appropriate discipline of its members and persons associated with members for violations of the federal securities laws and exchange rules, and Section 6(b)(7),<sup>116</sup> which requires the rules of an exchange to provide a fair procedure for the disciplining of members and persons associated with members, in that they are designed to provide fair procedures for the disciplining of members and persons associated with members. The Commission further finds that the proposal is 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 Exchange.<sup>117</sup>

**E. Trading Permits**

Prior to the Restructuring Transaction, Exchange memberships provided trading access to the Exchange. After the Restructuring Transaction, "Trading Permits" would provide trading access to the Exchange.<sup>118</sup> A person or entity that holds a Trading Permit would be referred to as

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<sup>115</sup> 15 U.S.C. 78f(b)(6).

<sup>116</sup> 15 U.S.C. 78f(b)(7).

<sup>117</sup> See Section 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1).

<sup>118</sup> See proposed CBOE Rule 1.1(ggg) (defining Trading Permit). "Trading Permits" would be defined as licenses issued by the Exchange that grant the holders or the holders' nominee the right to access the Exchange or one or more of its facilities for the purpose of effecting transactions in securities traded on the Exchange without the services of another person acting as broker, and otherwise to access the Exchange or its facilities for purposes of trading or reporting transactions or transmitting orders or quotations in securities traded on the Exchange, or to engage in other activities that, under CBOE rules, may only be engaged in by holders of Trading Permits, provided that the holder or the holder's nominee, as applicable, satisfies any applicable qualification requirements to exercise those rights.

a "Trading Permit Holder."<sup>119</sup> Trading Permit Holders would meet the definition of "member" in Section 3(a)(3)(A) of the Act.<sup>120</sup> As members under the Act, Trading Permit Holders and their nominees would be subject to the regulatory jurisdiction of the Exchange, including the Exchange's disciplinary jurisdiction under Chapter XVII of the CBOE Rules.<sup>121</sup>

A Trading Permit would not convey any ownership interest in the Exchange, would only be available through the Exchange, and would be subject to the terms and conditions set forth in proposed CBOE Rule 3.1. As a result of the Exchange's proposed new structure in which ownership would be separated from trading access, the Exchange is planning to propose separately to replace the term "member" throughout its rules with the term "Trading Permit Holder."<sup>122</sup>

(1) Features of Trading Permits

The Exchange would have the authority to issue different types of Trading Permits that allow holders thereof to trade one or more products authorized for trading on the Exchange and to act in one or more authorized trading functions. Trading Permits would be for set terms specified by the Exchange.<sup>123</sup> The Exchange expects initially to offer Trading Permits for terms

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<sup>119</sup> See proposed Section 1.1(f) of the CBOE Bylaws (defining Trading Permit Holder) and proposed CBOE Rule 1.1(gg) (defining Trading Permit Holder). A "Trading Permit Holder" could be an individual, corporation, partnership, limited liability company, or other entity authorized by the CBOE rules to hold a permit.

<sup>120</sup> 15 U.S.C. 78c(a)(3)(A). As described in Section II.C.2 above (Nomination and Election of Directors), the selection process for Representative Directors for the CBOE Board addresses the fair representation requirement for members contained in Section 6(b)(3) of the Act. 15 U.S.C. 78f(b)(3). See also *supra* note 39 (defining "Trading Permit Holder").

<sup>121</sup> See proposed CBOE Rule 3.1(a)(iii).

<sup>122</sup> This change will cause a significant number of the Exchange's rules to be amended. The Exchange intends to submit a separate filing to change the term "member" to "Trading Permit Holder" in the remainder of its rules and forms, as well as to make certain other related conforming changes.

<sup>123</sup> See proposed CBOE Rule 3.1(a)(iv).

of one month, three months, and one year, and would announce in a circular the types of permits it has determined to offer.<sup>124</sup> Trading Permits would be subject to such fees and charges as are established by the Exchange from time to time.<sup>125</sup>

The Exchange would have the authority to increase the number of any type of Trading Permit it has determined to issue.<sup>126</sup> The Exchange also would have the authority to limit or reduce the number of any type of Trading Permit it has determined to issue,<sup>127</sup> although the Exchange would be prohibited from eliminating or reducing the ability to trade one or more product(s) of a person currently trading such product(s) and would be prohibited from eliminating or reducing the ability to act in one or more trading function(s) of a person currently acting in such trading function(s), unless the Exchange is permitted to do so pursuant to a rule

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<sup>124</sup> See Notice, *supra* note 4, 73 FR at 51663.

<sup>125</sup> See proposed CBOE Rule 3.1(a)(v). The Exchange would be required to file proposed rule changes under Section 19(b) of the Act, 15 U.S.C. 78s(b), including, as applicable, Section 19(b)(3)(A)(ii), 15 U.S.C. 78s(b)(3)(A)(ii), to establish or change the fees for the types of Trading Permits it determines to issue.

<sup>126</sup> See proposed CBOE Rule 3.1(a)(vii).

<sup>127</sup> See proposed CBOE Rule 3.1(a)(vi). The Exchange would only be permitted to limit or reduce the number of any type of Trading Permit in a manner that complies with Section 6(c)(4) of the Act (15 U.S.C. 78f(c)(4)). See proposed CBOE Rule 3.1(a)(vi). The Exchange would retain the authority to take any action (remedial or otherwise) under the Act, the Bylaws, and the Rules. For example, the Exchange would continue to have the authority to take disciplinary action against a person over which the Exchange has jurisdiction. See proposed CBOE Rule 3.1(a)(ix).

As noted in a letter submitted by the Exchange to the Commission in connection with SR-CBOE-2006-106, CBOE has been unable to locate records that reflect with certainty the number of CBOE memberships on May 1, 1975. See Letter from Joanne Moffic-Silver, Executive Vice President, General Counsel and Corporate Secretary, CBOE, to Richard Holley III, Senior Special Counsel, Division of Market Regulation, Commission, dated November 2, 2007 (<http://www.sec.gov/comments/sr-cboe-2006-106/cboe2006106-161.pdf>). The closest date to May 1, 1975 for which CBOE has been able to locate records that CBOE believes can be relied upon to establish this information is June 30, 1975. Specifically, CBOE has financial statements as of June 30, 1975, the end of its then fiscal year, which set forth this information as of that date. The number of CBOE memberships on June 30, 1975 was 1,025.

filing submitted to Commission under Section 19(b) of the Act.<sup>128</sup> The Exchange would announce in a circular any limitation or reduction in the number of Trading Permits it seeks to impose. In addition, the Exchange would have the authority, pursuant to a rule filing submitted to the Commission under Section 19(b) of the Act,<sup>129</sup> to establish objective standards that must be met to obtain or renew a Trading Permit.<sup>130</sup>

Trading Permits could not be leased or transferred to any person except that an organization holding a Trading Permit may change the designation of the nominee in respect of each Trading Permit it holds or a Trading Permit Holder may, with the prior written consent of the Exchange, transfer a Trading Permit to a Trading Permit Holder organization or to an organization approved to be a TPH organization which is an affiliate or which continues substantially the same business without regard to the form of the transaction used to achieve such continuation.<sup>131</sup>

(2) Issuance of Trading Permits

In connection with the Restructuring Transaction, each current member of the Exchange that has the ability to trade would be eligible to receive a Trading Permit. Specifically, provided such person submits a post-Restructuring Transaction trading application to the Exchange,<sup>132</sup> is in good standing as of the date of the Restructuring Transaction, complies with the application procedures established by the Exchange, and pays any applicable fees, the Exchange would issue

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<sup>128</sup> 15 U.S.C. 78s(b).

<sup>129</sup> 15 U.S.C. 78s(b).

<sup>130</sup> See proposed CBOE Rule 3.1(a)(viii). Rule 3.1 provides that notwithstanding Rule 3.1 and Rule 3.1A (which addresses the issuance of Trading Permits to current members) nothing in those rules would eliminate or restrict the Exchange's authority to delist any product or to take any action under the Act, the Bylaws and the Rules. See proposed CBOE Rule 3.1(a)(ix).

<sup>131</sup> See proposed CBOE Rule 3.1(d)(ii).

<sup>132</sup> See proposed CBOE Rule 3.1A(a).

to such person a Trading Permit in respect of: (A) each membership not subject to an effective lease as of the date of the Restructuring Transaction that is owned by the applicant; (B) each membership that is leased as a lessee by the applicant as of the date of the Restructuring Transaction; (C) each trading permit issued by the Exchange prior to the Restructuring Transaction that is held by the applicant,<sup>133</sup> provided that in the case of a CBSX trading permit, the Exchange would issue a Trading Permit in respect of the CBSX trading permit that only provides the right to effect transactions on the CBSX;<sup>134</sup> and (D) each Temporary Membership held pursuant to Interpretation and Policy .02 of CBOE Rule 3.19.<sup>135</sup> Trading Permits also would be available, pursuant to an application process, to persons seeking trading access to the Exchange for the first time, as well as persons seeking to obtain additional Trading Permits.

Persons who are issued Trading Permits as set forth above would have the ability pursuant to those Trading Permits to continue trading any product, and acting in any trading function, that those persons traded, or acted in, at the time of the Restructuring Transaction.<sup>136</sup>

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<sup>133</sup> See Securities Exchange Act Release No. 58178 (July 17, 2008), 73 FR 42634 (July 22, 2008) (SR-CBOE-2008-40) (approving issuance of 50 Interim Trading Permits "ITPs"). Pursuant to Rule 3.27, the Exchange was authorized to issue ITPs to address the demand for trading access to the Exchange to the extent that a shortage exists from time to time in the number of transferable Exchange memberships available for lease.

<sup>134</sup> CBOE Rule 3.26, which currently provides for the issuance of CBSX trading permits, would be deleted as part of this rule filing because all Trading Permits after the Restructuring Transaction would be issued under proposed CBOE Rule 3.1. For the same reason, CBOE Rule 3.27, which currently provides for the issuance of Interim Trading Permits, also would be deleted.

<sup>135</sup> A person who was eligible to receive Trading Permit(s) pursuant to any of these provisions but who failed to comply with the application or other requirements must submit an application for a new Trading Permit and must go through the approval process to hold a Trading Permit. See proposed CBOE Rule 3.1A(c).

<sup>136</sup> This guarantee is subject to Rule 3.1(a)(iv), which provides that nothing in Rules 3.1 or 3.1A would eliminate or restrict the Exchange's authority to delist any product or to take any action (remedial or otherwise) under the Act, the Bylaws, and the Rules, including without limitation the Exchange's authority to take disciplinary or market performance actions against a person with respect to which the Exchange has jurisdiction under the Act, the Bylaws, and the Rules. See supra note 130. In addition, this guarantee is subject to the continuing satisfaction of any

The Exchange would have the ability to issue one or more types of Trading Permits through either a random lottery process or an order in time process.<sup>137</sup> In connection with an issuance of such Trading Permits, a Qualified Person<sup>138</sup> and any affiliated Qualified Person would be eligible to receive no more than the greater of 10 such Trading Permits or 20% of the number of Trading Permits issued at any given time.<sup>139</sup> This limit, however, would not apply in the event the number of permits to be issued exceeds the demand for such permits, in which case permits would be made available through the order in time process.<sup>140</sup>

The Exchange would automatically renew a Trading Permit for the same term as the expiring term,<sup>141</sup> unless, with advance notice to the Exchange and in a form and manner

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applicable qualification requirements, as well as to the Exchange's ability discussed above to limit or reduce the number of any type of Trading Permit pursuant to a rule filing with the Commission. See proposed CBOE Rules 3.1A(a) and 3.1(a)(vi).

<sup>137</sup> See proposed CBOE Rule 3.1(b)(iii). The Exchange also would have the authority to modify these processes or to establish any other objective process to issue Trading Permits pursuant to a rule filing submitted to the Commission under Section 19(b) of the Act (15 U.S.C. 78s(b)).

The Exchange in its discretion may maintain a waiting list to be used to issue Trading Permits pursuant to the order in time process. See proposed CBOE Rule 3.1(b)(ii). If the Exchange maintains a waiting list, Qualified Persons would be placed on that waiting list based on the order in time that such persons submitted applications, and such persons may at any time voluntarily withdraw from that waiting list. A person on the waiting list would be permitted to adjust the number of Trading Permits that such person would like to receive at any time prior to an announcement of an issuance of such Trading Permits.

<sup>138</sup> See proposed CBOE Rule 8.1(b)(i) (defining Qualified Person).

<sup>139</sup> See proposed CBOE Rule 3.1(b)(iii).

<sup>140</sup> See id.

<sup>141</sup> See proposed CBOE Rule 3.1(c)(iii). In renewing a Trading Permit, the Exchange would have the authority to issue one or more Trading Permits that represent the same or more trading right(s) as the expiring permit. See proposed CBOE Rule 3.1(c)(ii). To the extent the Exchange determines to issue one or more Trading Permits that represent the same or more trading right(s) as an expiring Trading Permit, the Exchange would provide all holders of that type of expiring Trading Permit with the new Trading Permit(s).

prescribed by the Exchange, the holder seeks to terminate the permit<sup>142</sup> or seeks to change the type of Trading Permit held.<sup>143</sup>

The Commission finds that the proposed CBOE rules governing the nature and issuance of Trading Permits are consistent with the Act, including Section 6(b)(2) of the Act,<sup>144</sup> which requires that a national securities exchange have rules that provide that any registered broker or dealer may become a member and any person may become associated with an exchange member.<sup>145</sup> The Commission notes that pursuant to Section 6(c) of the Act,<sup>146</sup> an exchange must deny membership to non-registered broker-dealers and registered broker-dealers that do not satisfy certain standards, such as financial responsibility or operational capacity.

(3) Tier Appointments

The Exchange has proposed a new type of appointment called a "tier appointment" for a market-maker seeking to trade one or more options classes.<sup>147</sup> Tier appointments would be subject to an application process similar to the process applicable for Trading Permits (*i.e.*, the random lottery or order in time processes).<sup>148</sup> Notwithstanding this application requirement, in the event a current member of the Exchange at the time of the Restructuring Transaction is trading an options class with respect to which the Exchange is establishing a tier appointment, the Exchange in connection with the Restructuring Transaction would issue to that member such

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<sup>142</sup> See proposed CBOE Rule 3.1(c)(i).

<sup>143</sup> See proposed CBOE Rule 3.1(c)(ii).

<sup>144</sup> 15 U.S.C. 78f(b)(2).

<sup>145</sup> See, *e.g.*, BATS Exchange Registration Order and Nasdaq Exchange Registration Order, *supra*, note 78, 73 FR at 59502 and 71 FR at 3555, respectively.

<sup>146</sup> 15 U.S.C. 78f(c).

<sup>147</sup> See proposed CBOE Rule 8.3.

<sup>148</sup> See proposed CBOE Rule 8.3(e).

tier appointment, provided that the Exchange is notified of that member's desire to hold such a tier appointment.<sup>149</sup> Tier appointments would be in addition to the current appointment cost process set forth in CBOE Rule 8.3, which would remain unchanged.<sup>150</sup>

Market-makers would be required to designate a Trading Permit with which a tier appointment would be associated and could designate no more than one tier appointment per Trading Permit.<sup>151</sup> Tier appointments would be for the same term as the Trading Permit with which the tier appointment is associated. Termination, change, renewal, and transfer of tier appointments would be subject to the same terms and conditions as the processes for Trading Permits.<sup>152</sup> The Exchange would have the authority to establish, increase, limit, or reduce the number of a type of tier appointment and to establish objective standards for a market-maker to be issued, or to have renewed, a particular type of tier appointment.<sup>153</sup> Tier appointments would be subject to such fees and charges as are established by the Exchange from time to time.<sup>154</sup>

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<sup>149</sup> See proposed CBOE 3.1A(b).

<sup>150</sup> In general, under that process, the number of memberships owned or leased by a market-maker serves as the basis for determining the number/types of options classes that the market-maker can trade. In this regard, each membership held by a market-maker has an appointment credit of 1.0, and each option listed on the Exchange has an assigned appointment cost. Under that process, for example, a Market-Maker with one membership could trade options on the Nasdaq 100 Index, which has an appointment cost of .50, and options on the CBOE Volatility Index, which also has an appointment cost of .50. See Notice, *supra* note 4, 73 FR at 51665.

<sup>151</sup> See proposed CBOE Rule 8.3(e).

<sup>152</sup> For example, if a holder of a tier appointment does not notify the Exchange that the holder wants to terminate that tier appointment and does not file an application to replace that tier appointment, that tier appointment would be renewed along with its associated Trading Permit for the same term as the expiring term of that Trading Permit.

<sup>153</sup> See proposed Rule 8.3 that provides that notwithstanding the rule, nothing therein would eliminate or restrict the Exchange's authority to delist any product or to take any action under the Act, the Bylaws and the Rules. The application process and issuance of tier appointments as specified in Rule 8.3 would be in accordance with, and subject to the same terms and conditions as, the issuance process set forth for Trading Permits in Rule 3.1(b). Termination, change, renewal, and transfer of tier appointments would be in accordance with, and subject to the same terms and conditions as, the process set forth for Trading Permits in Rule 3.1(c) and (d). If it



The Commission finds that the proposed CBOE rules governing tier appointments are consistent with the Act, including Section 6(b)(2) of the Act,<sup>155</sup> which requires that a national securities exchange have rules that provide that any registered broker or dealer may become a member. In particular, the proposal would preserve the existing appointments of current CBOE market-makers, and any new or expanded tier appointments would be allocated in accordance with, and subject to the same terms and conditions as, the issuance process set forth for Trading Permits in Rule 3.1(b). To the extent the Exchange seeks to limit or reduce any type of tier appointment, the Commission notes that the Exchange would need to do so in an equitable and not unfairly discriminatory manner and file any such proposal with the Commission pursuant to Section 19 of the Act.

**F. Other Changes to the Rules**

(1) Chapter I of the Rules

The Exchange has proposed amended definitions in Chapter I to reflect the use of Trading Permits.<sup>156</sup> The Exchange also proposed a definition of its new "TPH Department,"<sup>157</sup> which would serve as the successor to CBOE's Membership Department and would continue the

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seeks to limit or reduce the number of a type of tier appointment, or establish other objective standards governing issuance and/or renewal of a particular type of tier appointment, the Exchange first would need to file with the Commission a proposed rule change under Section 19(b) of the Act, 15 U.S.C. 78s(b).

<sup>154</sup> The Exchange would be required to file proposed rule changes under Section 19(b) of the Act, 15 U.S.C. 78s(b), including, as applicable, Section 19(b)(3)(A)(ii), 15 U.S.C. 78s(b)(3)(A)(ii), to establish and change the fees for the types of Trading Permits it has determined to issue.

<sup>155</sup> 15 U.S.C. 78f(b)(2).

<sup>156</sup> For example, the Exchange proposed to delete the terms "Lessor" and "Lessee" (since these concepts would not exist after the Restructuring Transaction) and added proposed definitions of "person," "Trading Permit," and "Trading Permit Holder." See proposed CBOE Rules 1.1(ff) and (gg). A "person" would be defined as an individual, partnership (general or limited), joint stock company, corporation, limited liability company, trust or unincorporated organization, or any governmental entity or agency or political subdivision thereof.

<sup>157</sup> See proposed CBOE Rule 1.1(iii) (defining TPH Department).

functions of that department, such as processing applications for Trading Permits. The Commission finds the proposed changes to Chapter I of CBOE's rules to be consistent with the Act as they are necessary to update the terms used in the rules and would assist Trading Permit Holders and the public in understanding the application and scope of CBOE's rules.

(2) Chapter II of the Rules

CBOE has proposed several clarifying amendments to CBOE Rule 2.1, including limiting its scope to Exchange committees (i.e., committees that are not solely composed of CBOE directors) and clarifying the manner of appointment to such committees to reflect the fact that the Vice Chairman of the Board, with the approval of the CBOE Board, would appoint the chairmen and members of committees (other than the BCC)<sup>158</sup> unless otherwise provided by the rules of CBOE or by the CBOE Board.<sup>159</sup> CBOE has also proposed to streamline the process for filling vacancies on Exchange committees (other than the BCC)<sup>160</sup> and would provide that a majority would generally constitute a quorum for committee meetings.<sup>161</sup> The proposed revision would also clarify that committees could take all types of actions, not only "informal" actions, pursuant to written consent.<sup>162</sup>

Further, CBOE has proposed to clarify certain aspects of the authority of the CBOE Board over committees, including a clarification that the CBOE Board may delegate powers and duties to the committees and that each Exchange committee is subject to the control and

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<sup>158</sup> After the Restructuring Transaction, the President, with approval of the Board, would continue to have the authority to appoint members to the Business Conduct Committee. See proposed CBOE Rules 2.1(a). See also Notice, supra note 4, 73 FR at 51666.

<sup>159</sup> See proposed CBOE Rule 2.1(a).

<sup>160</sup> See id.

<sup>161</sup> See proposed CBOE Rule 2.1(b).

<sup>162</sup> See proposed CBOE Rules 2.1(b).

supervision of the CBOE Board.<sup>163</sup> CBOE proposed to clarify that the CBOE Board has the authority to review, modify, suspend, or overrule any and all actions of any committee, officer, representative, or designee of the Exchange taken pursuant to the rules in accordance with any applicable review procedures specified in the rules.<sup>164</sup> Finally, CBOE proposed conforming changes to the rules in Chapter II to reflect the use of the term Trading Permits.<sup>165</sup>

The Commission finds that the proposed changes to Chapter II of CBOE's rules are consistent with the Act in that they clarify the operation of Exchange committees and the authority of the CBOE Board and also update the terms used in the rules to reflect the proposed Restructuring Transaction, therein clarifying the application and scope of CBOE's rules.

(3) Chapter III of the Rules

CBOE has proposed conforming changes to certain rules in Chapter III to reflect the change from memberships to Trading Permits without changing the substance of these rules.<sup>166</sup> In addition, the process for designating nominees for Trading Permits in CBOE Rule 3.8 would be amended to require an organization to designate as its nominee an associated person who is an

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<sup>163</sup> See proposed CBOE Rules 2.1(d) and 2.1(e).

<sup>164</sup> See proposed CBOE Rule 2.2.

<sup>165</sup> For example, references to the term "dues" have been deleted in CBOE Rules 2.20, 2.22, and 2.23 because this term generally refers to payments made by members in a membership organization. This change also has been made to other rules in Chapters I-III. See, e.g., CBOE Rule 1.1(jj).

<sup>166</sup> For example, rules relating to the sale, transfer, and lease of memberships, and to the member death benefit would be deleted, because they would not be applicable to Trading Permits. See, e.g., CBOE Rules 3.12-3.15. CBOE Rules 3.24 (regarding member death benefit) and 3.25 (regarding transfer of memberships in trust) would also be deleted. In addition, CBOE Rule 3.1, which was designed to, among other things, ensure that memberships were used for trading on the Exchange, would be replaced with a new version as this requirement would not be necessary in the context of Trading Permits that, unlike memberships, are directly linked to having a trading function on the Exchange. Other conforming changes are being proposed to CBOE Rules 3.2 and 3.3 (relating to the qualifications to be a member or member organization, and the application process to become a member; 3.5 (relating to the authority of the Exchange to deny or condition persons from becoming or being associated with Trading Permit Holders); 3.18 (regarding statutory disqualification); and Rule 3.10 (regarding status of Trading Permit Holders).

individual holder of a Trading Permit.<sup>167</sup> Further, the Exchange proposes to streamline the process of designating nominees for organizations that have multiple Trading Permits in their name. As modified, CBOE Rule 3.8(a)(ii) would allow organizations to designate the same individual to be the nominee for Trading Permits held in its name, including Trading Permits used for trading in open outcry on the trading floor.<sup>168</sup>

The Exchange also is deleting the requirement in CBOE Rule 3.7(g) that a member keep and maintain a current copy of the CBOE Constitution and rules in a readily accessible place and available for examination by customers. CBOE believes that, because it is required to maintain a copy of its governing documents and rules online, this requirement is no longer necessary.<sup>169</sup> Finally, the Exchange is amending CBOE Rule 3.9 to, among other things, delete the requirement that the Exchange post notices of applications on the Exchange Bulletin Board, as it believes that use of a physical bulletin board at the Exchange to notify persons is outdated in the era of electronic and remote trading.<sup>170</sup>

**G. Request for Commission Approval under Section 15.16 of the CBSX Operating Agreement**

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<sup>167</sup> See CBOE Rule 3.8(a). References to registering a membership for a member organization would be deleted because that concept would have no application once Trading Permits are used to provide trading access to the Exchange. See proposed CBOE Rule 3.8. The Exchange also would make this change to other rules in Chapters I-III and to CBOE Rule 8.3. See Notice, *supra* note 4, 73 FR at 51667, n.180.

<sup>168</sup> Under the existing rule, a member organization that has multiple memberships in its name can designate the same individual to be the nominee for those memberships, except that for each membership used for trading in open outcry on the trading floor, the member organization must designate a different individual to be the nominee for each of those memberships.

<sup>169</sup> See Notice, *supra* note 4, 73 FR at 51667.

<sup>170</sup> The information would continue to be published in the electronic Exchange Bulletin. See CBOE Rule 3.9(e). The Exchange also would post notices of the effectiveness of Trading Permit Holder status or approval of a trading function in the Exchange Bulletin. See proposed CBOE Rule 3.11.

Under the CBSX Operating Agreement, CBOE is defined as one of the “Owners” of CBSX. Section 15.16 of the CBSX Operating Agreement provides that, in the event that a person acquires a 25% or greater interest in an Owner that owns a 20% or greater interest in CBSX, that person must execute an amendment to the Operating Agreement in which that person agrees to be a party to the Operating Agreement and to abide by all of the provisions of the Operating Agreement. Section 15.16 also provides that Commission approval under Section 19 of the Act is required in connection with such an amendment to the Operating Agreement.<sup>171</sup> Because CBOE owns a 50% interest in CBSX, the establishment of CBOE Holdings as the sole shareholder of CBOE would trigger this Commission approval requirement. Consistent with this requirement in Section 15.16 of the CBSX Operating Agreement, CBOE has requested as part of this proposed rule change that the Commission provide such approval.

The provision in the CBSX Operating Agreement requiring Commission approval of an amendment to the CBSX Operating Agreement to effectuate a change in control was designed to involve the Commission and CBOE in assessing the potential conflicts of control that could arise. In the case of the Restructuring Transaction, CBOE would become wholly-owned by CBOE Holdings. However, as discussed in detail above, CBOE Holdings would be subject to a number of conditions designed to protect the regulatory independence of CBOE in recognition of its status as an SRO. Accordingly, the Commission finds that the amendment to the CBSX Operating Agreement with respect to the change in control of CBOE in connection with the Restructuring Transaction is consistent with the Act.

#### H. Accelerated Approval

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<sup>171</sup> 15 U.S.C. 78s.

CBOE has asked the Commission to grant accelerated approval of the proposal, as modified by Amendment No. 1. As set forth below, the Commission finds good cause for approving the proposal, as modified by Amendment No. 1, prior to the thirtieth day after publishing notice of Amendment No. 1 in the Federal Register.<sup>172</sup>

In Amendment No. 1, CBOE proposed the following modifications to the proposed CBOE Holdings governing documents: (1) issuance of a single class of common stock of CBOE Holdings, rather than different series of common stock as was originally proposed; (2) minor revisions to the transfer restrictions on common stock; (3) incorporation of the term "Regulated Securities Exchange Subsidiary," rather than "CBOE," to accommodate the potential future ownership of more than one national securities exchange by CBOE Holdings; (4) requiring that shares of stock issued in connection with the Restructuring Transaction be recorded on the books and records of CBOE Holdings only in the name of the owner of the shares to ensure compliance with the transfer restrictions; (5) changes to the size of the CBOE Holdings Board and term of its Directors; (6) defer for one year the date of the first annual meeting of CBOE Holdings stockholders, and thus the first election of post-Restructuring Transaction directors; (7) changes to the content of the notice stockholders must submit in connection with director nominations or stockholder requests to bring matters before the annual stockholder meeting; (8) the ability to set separate record dates for stockholder notice of a stockholder meeting and for voting purposes; (9) specify that two-thirds of CBOE Holdings directors must satisfy the independence requirements contained in the listing standards of either NYSE or The Nasdaq Stock Market; (10) modify the "for cause" removal standard applicable to directors in light of the change to one-year terms for

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<sup>172</sup> 15 U.S.C. 78s(b)(2). Pursuant to Section 19(b)(2) of the Act, the Commission may not approve any proposed rule change, or amendment thereto, prior to the thirtieth day after the date of publication of notice thereof, unless the Commission finds good cause for so doing.

directors; (11) delete the requirement that at least one director on the CBOE Holdings Compensation Committee be the beneficial owner of CBOE Holdings stock; (12) changes to the size of the CBOE Holdings Nominating and Governance Committee; and (13) make certain technical, non-substantive wording changes.

In addition, Amendment No. 1 proposes the following changes to the proposed CBOE governing documents: (1) changes to the size of the CBOE Board and term of its Directors; (2) defer for one year the date of the first annual meeting of CBOE stockholders, and thus the first election of post-Restructuring Transaction directors; (3) modify the "for cause" removal standard applicable to directors in light of the change to one-year terms for directors; (4) delete the requirement that at least one director on the CBOE Compensation Committee be the beneficial owner of CBOE Holdings stock; (5) change the requisite number of directors on the Regulatory Oversight Committee from four to three; (6) revise the provision dealing with the duties and powers of the CBOE Treasurer to make the provision the same as a similar provision set forth in the CBOE Holdings corporate documents; and (7) correct non-substantive typographical errors.

Finally, Amendment No. 1 seeks to make the following changes to the proposed CBOE Rules: (1) adopt a rule governing the permissible uses of regulatory revenues; and (2) make certain changes to reflect intervening proposed rule changes that have been submitted since CBOE filed its proposal.

The Commission believes that the changes contained in Amendment No. 1 are consistent with the Act. The Commission notes that the changes proposed in Amendment No. 1 are either not material or are otherwise responsive to the concerns of the Commission and do not raise any regulatory concerns. In addition, the Commission notes that the initial proposed rule change was published for comment with a comment period ending on September 25, 2008 and the

Commission did not receive any comments on the proposal. Accordingly, the Commission finds that good cause exists for approving the proposed rule change, as amended, on an accelerated basis, pursuant to Section 19(b)(2) of the Act.<sup>173</sup>

### **III. 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](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2008-88 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-2008-88. 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

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<sup>173</sup> 15 U.S.C. 78s(b)(2).



that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. 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-2008-88 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

**IV. Conclusion**

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>174</sup> that the proposed rule change (SR-CBOE-2008-88), as modified by Amendment No. 1, be and hereby is approved on an accelerated basis.

By the Commission.



Elizabeth M. Murphy  
Secretary

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<sup>174</sup> 15 U.S.C. 78s(b)(2).

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

May 25, 2010

IN THE MATTER OF  
ACT CLEAN TECHNOLOGIES, INC.

ORDER OF SUSPENSION  
OF TRADING

File No. 500-1

It appears to the Securities and Exchange Commission ("Commission") that there is a lack of current and accurate information concerning the securities of ACT Clean Technologies, Inc. ("ACT") because of questions regarding the accuracy of assertions by ACT concerning, among other things: (1) British Petroleum's purported expression of interest in using a so-called oil fluidizer technology purportedly licensed to ACT's wholly-owned subsidiary, American Petroleum Solutions, Inc., for use in cleanup operations in the Gulf of Mexico, and its purported request that field tests be conducted on the oil fluidizer technology; and (2) the purported results of field tests finding that the oil fluidizers are effective for use in clean up efforts in the Gulf of Mexico.

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

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the above-listed company is suspended for the period from 9:30 a.m. EDT, May 25, 2010 through 11:59 p.m. EDT, on June 8, 2010.

By the Commission.

*Elizabeth M. Murphy*  
Elizabeth M. Murphy  
Secretary

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**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR PART 242**

[Release No. 34-62174; File No. S7-11-10]

**RIN 3235-AK51**

**Consolidated Audit Trail**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission ("Commission") is proposing new Rule 613 under Section 11A(a)(3)(B) of the Securities Exchange Act of 1934 ("Exchange Act") that would require national securities exchanges and national securities associations ("self-regulatory organizations" or "SROs") to act jointly in developing a national market system ("NMS") plan to develop, implement, and maintain a consolidated order tracking system, or consolidated audit trail, with respect to the trading of NMS securities.

The Commission preliminarily believes that with today's electronic, interconnected markets, there is a heightened need for regulators to have efficient access to a more robust and effective cross-market order and execution tracking system. Currently, many of the national securities exchanges and the Financial Industry Regulatory Authority, Inc. ("FINRA") have audit trail rules and systems to track information relating to orders received and executed, or otherwise handled, in their respective markets. While the information gathered from these audit trail systems aids the SRO and Commission staff in their regulatory responsibility to surveil for compliance with SRO rules and the federal securities laws and regulations, the Commission preliminarily believes that existing audit trails are limited in their scope and effectiveness in varying ways. In addition, while the SRO and Commission staff also currently receive

information about orders or trades through the electronic bluesheet ("EBS") system, Rule 17a-25 under the Exchange Act,<sup>1</sup> or from equity cleared reports, the information is limited, to varying degrees, in detail and scope.

A consolidated audit trail would significantly aid in SRO efforts to detect and deter fraudulent and manipulative acts and practices in the marketplace, and generally to regulate their markets and members. In addition, such an audit trail would benefit the Commission in its market analysis efforts, such as investigating and preparing market reconstructions and understanding causes of unusual market activity. Further, timely pursuit of potential violations can be important in seeking to freeze and recover any profits received from illegal activity.

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

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

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File No. S7-11-10 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.

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<sup>1</sup> 17 CFR 240.17a-25.

All submissions should refer to File No. S7-11-10. 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 Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Rebekah Liu, Special Counsel, at (202) 551-5665; Jennifer Colihan, Special Counsel, at (202) 551-5642, or Leigh W. Duffy, Attorney-Adviser, at (202) 551-5928, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

**SUPPLEMENTARY INFORMATION:**

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**I. Background**

The U.S. securities markets have undergone a significant transformation over the last few decades, and particularly in the last few years. Regulatory changes and technological advances have contributed to a tremendous growth in trading volume and the further distribution of order flow across multiple trading centers. Today's markets are widely dispersed, with securities often trading on multiple markets, including over-the-counter ("OTC"). Additionally, products that are closely related in nature and objective are also traded on different markets. For example, various markets trade either options on the S&P 500 index,<sup>2</sup> futures on the S&P 500 index,<sup>3</sup> exchange traded funds ("ETFs") based on the S&P 500 index,<sup>4</sup> and options and futures on those ETFs.<sup>5</sup> This dispersion of significant trading volume has led the Commission in the past to ask for comment on how best to enhance the capability of SROs and the Commission to effectively and efficiently conduct cross-market supervision of trading activity.<sup>6</sup>

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<sup>2</sup> The Chicago Board Options Exchange, Incorporated ("CBOE") lists options on the S&P 500 Index (SPX) and on the Mini-S&P 500 Index (XSP) (1/10<sup>th</sup> the value of the S&P 500 Index).

<sup>3</sup> For example, the Chicago Mercantile Exchange Inc. ("CME") offers S&P 500 futures and "E-Mini" futures on the S&P 500 Index (\$50 x S&P 500 Index price).

<sup>4</sup> For example, NYSE Arca, Inc. ("NYSE Arca") lists an ETF based on the S&P 500 SPDR (SPY) and the iShares S&P 500 Index Fund (IVV).

<sup>5</sup> For example, OneChicago, LLC lists futures on the SPY, and CBOE lists options on the iShares S&P 500 Value Index Fund.

<sup>6</sup> See *infra* Section I.G. (discussing past Commission requests for comment on regulation of intermarket trading).

The individual SROs are responsible for regulating their markets and their members.<sup>7</sup> Further, the Commission has responsibilities to oversee the SROs, the securities markets, and registered broker-dealers, and routinely conducts examinations of or investigations into trading activity as part of its oversight and enforcement programs.<sup>8</sup> The SROs and the Commission need tools to effectively carry out these responsibilities even when trading occurs on multiple markets. For example, it is important that the SRO and Commission staff have order and trade data sufficient to monitor cross-market trading activity, assist with investigations of potential violations of federal securities laws and exchange rules, and perform market reconstructions or other analysis necessary to understand trading activity.<sup>9</sup> Such information also is important to the Commission in carrying out its oversight responsibilities.

The SROs' staff currently uses both EBS<sup>10</sup> and SRO audit trail data to help fulfill their regulatory obligations.<sup>11</sup> Commission staff also uses this data to perform its regulatory oversight

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<sup>7</sup> See, e.g., Sections 6(b)(1), 15A(b)(2), and 19(g) of the Exchange Act, 15 U.S.C. 78f(b)(1), 15 U.S.C. 78o-3(b)(2), and 15 U.S.C. 78s(g).

<sup>8</sup> See, e.g., Sections 2, 6(b)(1), 10, 15(b)(4)(D) and (E), and 19(h) of the Exchange Act, 15 U.S.C. 78b, 15 U.S.C. 78f(b)(1), 15 U.S.C. 78j, 15 U.S.C. 78o(b)(4)(D) and (E), and 15 U.S.C. 78s(h).

<sup>9</sup> As discussed below in Sections II and III, the Commission preliminarily believes that the proposal would improve the ability of regulators to conduct timely and accurate trading analyses for market reconstructions and complex investigations, as well as inspections and examinations. Indeed, the Commission believes that the proposed consolidated audit trail, if implemented, would have significantly enhanced the Commission's ability to quickly reconstruct and analyze the severe market disruption that occurred on May 6, 2010. If approved and implemented, the proposal also would enhance the Commission's ability to similarly respond to future severe market events.

<sup>10</sup> Bluesheets are trading records requested by the Commission and SROs from broker-dealers that are used in regulatory investigations to identify buyers and sellers of specific securities.

<sup>11</sup> The Commission recently published for comment a proposal to establish a large trader reporting system. See Securities Exchange Act Release No. 61908 (April 14, 2010), 75 FR 21456 (April 23, 2010) ("Large Trader Proposal"). Under that proposal, large traders would be issued unique identifiers that they would be required to provide to the broker-

obligations. The Commission and SROs have depended on the bluesheet system for decades to request trading records from broker-dealers needed for regulatory inquiries. Most SROs also maintain their own specific audit trail requirements applicable to their members. As discussed more fully below, for example, the National Association of Securities Dealers ("NASD")<sup>12</sup> established the Order Audit Trail System ("OATS")<sup>13</sup> in 1996, and the New York Stock Exchange ("NYSE") implemented its Order Tracking System ("OTS")<sup>14</sup> in 1999. Beginning in 2000, several of the current options exchanges implemented the Consolidated Options Audit Trail System ("COATS").<sup>15</sup>

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dealers that execute transactions on their behalf, and the broker-dealers would be required to maintain, and provide to the Commission upon request, transaction records for each large trader customer. The large trader proposal is designed to address in the near term the Commission's current need for access to more information about large traders and their activities. As discussed below, the Commission anticipates that the proposed consolidated audit trail discussed in this release, which is much broader in scope, would take a significant amount of time to fully implement. This proposal would require that, if the Large Trader proposal is adopted, the large trader identification number be reported to the central repository as part of the identifying customer information. See proposed Rule 613(j)(2).

<sup>12</sup> In 2007, the NASD and the member-related functions of NYSE Regulation, Inc., the regulatory subsidiary of the New York Stock Exchange LLC ("NYSE"), were consolidated. As part of this regulatory consolidation, the NASD changed its name to FINRA. See Securities Exchange Act Release No. 56146 (July 26, 2007), 72 FR 42190 (August 1, 2007). FINRA and the National Futures Association ("NFA") are currently the only national securities associations registered with the Commission; however the NFA has a limited purpose registration with the Commission under Section 15A(k) of the Exchange Act, 15 U.S.C. 78o-3(k). See also Securities Exchange Act Release No. 44823 (September 20, 2001), 66 FR 49439 (September 27, 2001).

<sup>13</sup> See Securities Exchange Act Release No. 39729 (March 6, 1998), 63 FR 12559 (March 13, 1998) (order approving proposed rules comprising OATS) ("OATS Approval Order").

<sup>14</sup> See Securities Exchange Act Release No. 47689 (April 17, 2003), 68 FR 20200 (April 24, 2003) (order approving proposed rule change by NYSE relating to order tracking) ("OTS Approval Order").

<sup>15</sup> See In the Matter of Certain Activities of Options Exchanges, Administrative Proceeding File No. 3-10282, Securities Exchange Act Release No. 43268 (September 11, 2000) (Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the



Currently, there is significant disparity in the audit trail requirements among the exchanges and FINRA, especially with respect to the information captured by each.<sup>16</sup> Further, the information for each must be provided in different formats. The differences result in inconsistent requirements imposed on exchange and FINRA members, and also make it difficult to view trading activity across multiple markets. The lack of uniformity in, and cross-market compatibility of, SRO audit trails can make detection of illegal trading activity carried out across multiple markets and multiple products more difficult. The Commission has voiced concern about the lack of uniformity in, and cross-market compatibility of, the audit trails in the past.<sup>17</sup> The Commission preliminarily believes that these differences may hinder the ability of the SROs and the Commission to effectively view and regulate trading activity across markets.

Further, risks imposed on the markets by violative conduct can be substantially increased by automated trading, as market participants have the ability to trade numerous products and enormous volume in mere seconds. As trading venues have become more automated, and trading systems have become computerized, trading volumes have increased significantly,<sup>18</sup> and trading has become more dispersed across more trading centers and therefore more difficult to monitor and trace.<sup>19</sup> The Commission is concerned that current audit trail requirements are

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Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions) ("Options Settlement Order"). See also, e.g., Securities Exchange Act Release No. 50996 (January 7, 2005), 70 FR 2436 (order approving proposed rule change by CBOE relating to Phase V of COATS).

<sup>16</sup> See *infra* Sections I.C, I.D, I.E, and I.F.

<sup>17</sup> See *infra* Section I.G.

<sup>18</sup> For example, consolidated average daily share volume and trades in NYSE-listed stocks increased from just 2.1 billion shares and 2.9 million trades in January 2005, to 5.9 billion shares (an increase of 181%) and 22.1 million trades (an increase of 662%) in September 2009. See Large Trader Proposal, *supra* note 11, at 21456.

<sup>19</sup> See, e.g., Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010) ("Concept Release on Equity Market Structure") at 3594-3596.

insufficient to capture in a timely manner all of the information necessary to efficiently and effectively monitor trading activity in today's highly automated and dispersed markets. The Commission also is concerned that the current lack of cohesive, readily available order and execution information impacts the ability of the SROs and the Commission staff to effectively perform their respective regulatory and oversight responsibilities with respect to trading activity by market participants across markets and products.

**A. Electronic Bluesheets and Rule 17a-25**

The Commission and the SROs frequently request bluesheets from broker-dealers to aid in investigations of possible federal securities law violations and to create market reconstructions.<sup>20</sup> Until the late 1980s, bluesheets consisted of questionnaire forms that Commission and SRO regulatory staff mailed to firms to be manually completed and returned.<sup>21</sup> Obtaining bluesheets in this manner was particularly onerous as there were substantial delays in the production and receipt of the requested information. Additionally, the data was submitted in a variety of formats, making analysis time-consuming, and requests could result in vast amounts of information requiring lengthy manual examination.<sup>22</sup>

In the late 1980s, as the volume of trading and securities transactions dramatically increased, the manual bluesheet system was replaced by the EBS system.<sup>23</sup> The EBS system

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<sup>20</sup> See Securities Exchange Act Release No. 44494 (June 29, 2001), 66 FR 35836 (July 9, 2001) (File No. S7-12-00) ("Rule 17a-25 Adopting Release"), at 35836.

<sup>21</sup> Id.

<sup>22</sup> See Securities Exchange Act Release No. 25859 (June 27, 1988), 53 FR 25029 (July 1, 1988) (approving both the NYSE and the American Stock Exchange's ("Amex") rules for the electronic submission of transaction information).

<sup>23</sup> See Rule 17a-25 Adopting Release, supra note 20, at 3-4. See also, e.g., id. and Securities Exchange Act Release Nos. 26235 (November 1, 1988), 53 FR 44688 (November 4, 1988) (approving the CBOE rule for the electronic submission of transaction information); 26539 (February 13, 1989), 54 FR 7318 (February 17, 1989)

allows broker-dealers to electronically submit the requested information in a specific format and transmit it to the Securities Industry Automation Corporation ("SIAC").<sup>24</sup> SIAC then routes the information to the Commission or to an SRO as applicable.

The EBS system, supplemented by the requirements of Rule 17a-25 under the Exchange Act,<sup>25</sup> currently is used by Commission and SRO regulatory staff primarily to assist the staff in the investigation of possible federal securities law violations primarily involving insider trading and other market manipulations, and to conduct market reconstructions, especially following periods of significant market volatility.<sup>26</sup> In its electronic format, the EBS system provides detailed execution information upon request by the Commission and the SROs' staff for specific securities during specified time frames.<sup>27</sup> However, because the EBS system is designed for use in narrowly-focused enforcement investigations that generally involve trading in particular securities, it is less useful for large-scale market reconstructions and analyses involving numerous stocks during peak trading volume periods.<sup>28</sup>

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(approving the NASD's rule for the electronic submission of transaction information); and 27170 (August 23, 1989), 54 FR 37066 (September 6, 1989) (approving the Philadelphia Stock Exchange's rule for the electronic submission of transaction information).

<sup>24</sup> See Rule 17a-25 Adopting Release, *supra* note 20, at 35836. SIAC is a subsidiary of NYSE Euronext and serves as the securities information processor of the Consolidated Tape Plan ("CTA Plan"), which governs the dissemination of trade information; the Consolidated Quotation Plan ("CQ Plan"), which governs the dissemination of quotation information; and the Options Price Reporting Authority Plan ("OPRA Plan"), which governs the dissemination of trade and quotation information for listed options. In this capacity, it provides real time quotation and transaction information to market participants.

<sup>25</sup> 17 CFR 240.17a-25.

<sup>26</sup> See Rule 17a-25 Adopting Release, *supra* note 20, at 35836.

<sup>27</sup> EBS data does not, however, include the time of execution, and often does not include the identity of the beneficial owner. See *infra* note 147.

<sup>28</sup> A 1990 Senate Report acknowledged the immense value of the EBS system, but noted

In 2000, the Commission proposed Rule 17a-25 under the Exchange Act to supplement the existing EBS system with data elements incorporating institutional and professional trading strategies, to assist regulatory staff in reviewing and analyzing EBS data.<sup>29</sup> Adopted in June 2001,<sup>30</sup> the rule codified the requirement that broker-dealers submit to the Commission, upon request, information on their customer and proprietary securities transactions in an electronic format.<sup>31</sup> Rule 17a-25 requires submission of the same standard customer and proprietary transaction information that SROs request through the EBS system in connection with their market surveillance and enforcement inquiries.<sup>32</sup>

Specifically, for a proprietary transaction, Rule 17a-25 requires a broker-dealer to provide the following information electronically upon request: (1) clearing house number or alpha symbol used by the broker-dealer submitting the information; (2) clearing house number(s) or alpha symbol(s) of the broker-dealer(s) on the opposite side to the trade; (3) security identifier; (4) execution date; (5) quantity executed; (6) transaction price; (7) account number; (8) identity of the exchange or market where the transaction was executed; (9) prime broker identifier; (10) average price account identifier; and (11) the identifier assigned to the account by a depository institution.<sup>33</sup> For customer transactions, the broker-dealer also is required to include

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that "it is designed for use in more narrowly focused enforcement investigations that generally relate to trading in individual securities. It is not designed for use for multiple inquiries that are essential for trading reconstruction purposes." See S. Rep. No. 300, 101st Cong., 2d Sess. 2-5 (1990), at 48.

<sup>29</sup> See Securities Exchange Act Release No. 42741 (May 2, 2000), 65 FR 26534 (May 8, 2000) ("Rule 17a-25 Proposing Release").

<sup>30</sup> See Rule 17a-25 Adopting Release, supra note 20.

<sup>31</sup> Id. at 35836, and 17 CFR 240.17a-25.

<sup>32</sup> See e.g. NYSE Rule 410A and FINRA Rule 8211.

<sup>33</sup> See Rule 17a-25(a)(1) and Rule 17a-25(b)(1)-(3), 17 CFR 240.17a-25(a)(1) and 17 CFR 240.17a-25(b)(1)-(3).

the customer's name, customer's address, the customer's tax identification number, and other related account information.<sup>34</sup> The new data elements added by Rule 17a-25 – prime broker identifiers, average price account identifiers, and depository institution account identifiers – assist the Commission in aggregating, without double-counting, securities transactions by entities trading through multiple accounts at more than one broker-dealer.<sup>35</sup>

#### **B. Equity Cleared Reports**

In addition to the EBS system and Rule 17a-25, the Commission also relies upon the National Securities Clearing Corporation's ("NSCC")<sup>36</sup> equity cleared report for initial regulatory inquiries.<sup>37</sup> This report is generated on a daily basis by the SROs and is provided to the NSCC, in a database accessible by the Commission, and shows the number of trades and daily volume of all equity securities in which transactions took place, sorted by clearing member.

The information provided is end of day data and is searchable by security name and CUSIP

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<sup>34</sup> See Rule 17a-25(a)(2), 17 CFR 240.17a-25(a)(2). Rule 17a-25 also requires broker-dealers to submit, and keep current, contact person information for requests under the rule. This provision was designed to ensure that the Commission could effectively direct its data requests to broker-dealers. See Rule 17a-25 Proposing Release, supra note 29, at 26537.

<sup>35</sup> This information was deemed especially necessary for the creation of massive market reconstructions performed by Commission staff. See Rule 17a-25 Adopting Release, supra note 20, at 35836.

<sup>36</sup> NSCC is a subsidiary of the Deposit Trust and Clearing Corporation and provides centralized clearing information and settlement services to broker-dealers for trades involving equities, corporate and municipal debt, American depository receipts, exchange traded funds, and unit investment trusts.

<sup>37</sup> The Commission also uses the Options Cleared Report, with data supplied by the Options Clearing Corporation ("OCC"), for analysis of trading in listed options. OCC is an equity derivatives clearing organization that is registered as a clearing agency under Section 17A of the Exchange Act and operates under the jurisdiction of both the Commission and the Commodities Futures Trading Commission ("CFTC").

number.<sup>38</sup> Since the information made available on the report is limited to the date, the clearing firm, and the number of transactions cleared by each clearing firm on each SRO, it basically serves as a starting point for an investigation, providing a tool the Commission can use to narrow down which clearing firms to contact concerning a transaction in a certain security.

### C. FINRA's Order Audit Trail System

In 1996, the Commission instituted public administrative proceedings against the NASD, alleging that it failed to enforce and investigate potential misconduct by its members.<sup>39</sup> In settling the Commission's enforcement action, the NASD was ordered to design and implement an audit trail to enable it to reconstruct its markets promptly and effectively surveil them.<sup>40</sup> The Commission mandated that the audit trail at a minimum: (1) provide an accurate time-sequenced record of orders and transactions, beginning with the receipt of an order at the first point of contact between the broker-dealer and the customer or counterparty, and further documenting the life of the order through the process including execution, modification and cancellation; and (2) provide for market-wide synchronization of clocks used in connection with the new audit trail system.<sup>41</sup> In response to the order, the NASD created OATS.<sup>42</sup>

Currently, OATS is used to capture order information reported by FINRA members in equity securities listed on the Nasdaq Stock Market, Inc. ("Nasdaq") and OTC equity

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<sup>38</sup> A CUSIP number is a unique alphanumeric identifier assigned to a security and is used to facilitate the clearance and settlement of trades in the security.

<sup>39</sup> See In the Matter of National Association of Securities Dealers, Inc., Administrative Proceeding File No. 3-9056, Securities Exchange Act Release No. 37538 (August 8, 1996) (Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions).

<sup>40</sup> Id. at 11-12.

<sup>41</sup> Id.

<sup>42</sup> See FINRA Rules 7400 to 7470. See also OATS Approval Order, supra note 13.

securities.<sup>43</sup> OATS requires reporting members<sup>44</sup> to record and report to FINRA<sup>45</sup> detailed information covering the receipt and origination of an order,<sup>46</sup> order terms, transmission, and modification, cancellation and execution.<sup>47</sup> Specifically, for each of these stages in the life of an order, FINRA Rule 7440 requires the recording and reporting of the following information, as applicable, including but not limited to:

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<sup>43</sup> FINRA defines an OTC equity security as any equity security that (1) is not listed on a national securities exchange, or (2) is listed on one or more regional stock exchanges and does not qualify for dissemination of transaction reports via the facilities of the Consolidated Tape. See FINRA Rule 7410(1).

<sup>44</sup> A reporting member is a member that receives or originates an order and has an obligation to record and report information under FINRA Rules 7440 and 7450. A member shall not be considered a reporting member in connection with an order if the following conditions are met: (1) the member engages in a non-discretionary order routing process, pursuant to which it immediately routes, by electronic or other means, all of its orders to a single reporting member; (2) the member does not direct and does not maintain control over subsequent routing or execution by the receiving reporting member; (3) the receiving reporting member records and reports all information required under FINRA Rules 7440 and 7450 with respect to the order; and (4) the member has a written agreement with the receiving reporting member specifying the respective functions and responsibilities of each party to effect full compliance with the requirements of Rule 7440 and 7450. See FINRA Rule 7410(o).

<sup>45</sup> Each reporting member must record each item of information required by OATS in electronic form by the end of each business day. See FINRA Rule 7440(a)(3). Reporting members must transmit to OATS a report of order information whenever an order is originated, received, transmitted to another department within the member or to another member, modified, canceled, or executed. Each report shall be transmitted on the day such event occurred if the information is available that day. Order information reports may be aggregated into one or more transmissions. See FINRA Rule 7450(b)(2).

<sup>46</sup> OATS recording and reporting requirements apply to any oral, written, or electronic instruction to effect a transaction in an equity security listed on the Nasdaq Stock Market or an OTC equity security that is received by a member from another person for handling or execution, or that is originated by a department of a member for execution by the same or another member, other than any such instruction to effect a proprietary transaction originated by a trading desk in the ordinary course of a member's market making activities. See FINRA Rule 7410(j).

<sup>47</sup> See FINRA Rules 7440 and 7450.

- for the receipt or origination of the order,<sup>48</sup> the date and time the order was first originated or received by the reporting member; a unique order identifier; the market participant symbol of the receiving reporting member; and the material terms of the order;<sup>49</sup>
- for the internal or external routing of an order, the unique order identifier; the market participant symbol of the member to which the order was transmitted; the identification and nature of the department to which the order was transmitted if transmitted internally; the date and time the order was received by the market participant or department to which the order was transmitted; the material terms of the order as transmitted;<sup>50</sup> the date and time the order is transmitted; and the market participant symbol of the member who transmitted the order;
- for the modification or cancellation of an order, a new unique order identifier; original unique order identifier; the date and time a modification or cancellation was

<sup>48</sup> FINRA Rule 7440 also requires reporting of the account type; the identification of the department or terminal where an order is received from a customer; the identification of the department or terminal where an order is originated by a reporting member; and the identification of a reporting agent if the agent has agreed to take on the responsibilities of a reporting member under Rule 7450. See FINRA Rule 7440(b).

<sup>49</sup> The specific information required to be reported includes: the number of shares; designation as a buy or sell or short sale; designation of the order as market, limit, stop, or stop limit; limit or stop price; date on which the order expires and if the time in force is less than one day, the time when the order expires; the time limit during which the order is in force; any request by a customer that an order not be displayed, or that a block size be displayed, pursuant to Rule 604(b) of Regulation NMS; any special handling requests; and identification of the order as related to a program trade or index arbitrage trade. See FINRA Rule 7440(b).

<sup>50</sup> The specific information required includes the number of shares to which the transmission applies, and whether the order is an intermarket sweep order. See FINRA Rule 7440(c).



originated or received; and the date and time the order was first received or originated;<sup>51</sup> and

- for the execution of an order, in whole or in part, the unique order identifier; the designation of the order as fully or partially executed; the number of shares to which a partial execution applies and the number of unexecuted shares remaining; the date and time of execution; the execution price; the capacity in which the member executed the transaction; the identification of the market where the trade was reported; and the date and time the order was originally received.<sup>52</sup>

FINRA uses this information to recreate daily market activity for FINRA's market surveillance activities.<sup>53</sup>

#### D. NYSE's Order Tracking System

The Commission instituted public administrative proceedings against the NYSE in 1999, alleging that the exchange had failed to detect violations of federal securities laws and its own rules by its independent floor broker members, failed to police for performance-based compensation arrangements involving these members, and failed to adequately surveil them.<sup>54</sup>

<sup>51</sup> For cancellations or modification, the following information also is required: if the open balance of an order is canceled after a partial execution, the number of shares canceled; and whether the order was canceled on the instruction of a customer or the reporting member. See FINRA Rule 7440(d).

<sup>52</sup> For executions, the reporting member also must report its market participant symbol; its number assigned for purposes of identifying transaction data; and the identification number of the terminal where the order was executed. See FINRA Rule 7440(d).

<sup>53</sup> See OATS Reporting Technical Specifications, January 5, 2010, available at <http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p120686.pdf>.

<sup>54</sup> See In the Matter of New York Stock Exchange, Inc., Administrative Proceeding File No. 3-9925, Securities Exchange Act Release No. 41574 (June 29, 1999) (Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Ordering Compliance with Undertakings), at 4-5.

In settling the Commission's enforcement action, the NYSE was ordered to continue its development of an electronic floor system for the entry of order details prior to representation on the exchange floor, as well as to design and implement an audit trail to enable it to effectively surveil and reconstruct its market promptly, and facilitate the NYSE's effective enforcement of the federal securities laws and exchange rules.<sup>55</sup> Like OATS, this audit trail was required to provide an accurate, time-sequenced record of orders, quotations and transactions, documenting the life of an order from receipt through execution or cancellation. The NYSE also was required to provide for synchronization of all clocks used in connection with the audit trail.<sup>56</sup>

In response to the Commission's order, the NYSE created OTS.<sup>57</sup> OTS currently is used for the provision of audit trail data for orders<sup>58</sup> in NYSE and NYSE Amex-listed cash equity securities by NYSE and NYSE Amex members, including for orders in NYSE or NYSE Amex-listed cash equity securities initiated by a NYSE or NYSE Amex member or routed by a NYSE or NYSE Amex member to another market center for execution.<sup>59</sup> OTS is similar in scope to OATS, as detailed information is required to be recorded for the stages of an order's life, from origination and receipt and transmittal, through order modification, cancellation, and/or

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<sup>55</sup> Id. at 28–29.

<sup>56</sup> Id.

<sup>57</sup> See NYSE Rule 132B, and OTS Approval Order, supra note 14.

<sup>58</sup> OTS is applicable to all orders in NYSE-listed securities, regardless of account type (firm or customer). See NYSE Rule 132B(a)(1).

<sup>59</sup> See Securities Exchange Act Release No. 59022 (November 26, 2008), 73 FR 73683 (December 3, 2008). NYSE Alternext adopted NYSE Rules 1-1004 as the NYSE Alternext Equities Rules to govern all cash equities trading on the NYSE Alternext Trading Systems and NYSE Alternext Bonds. In March 2009, NYSE Alternext changed its name to NYSE Amex LLC ("NYSE Amex") (the successor to Amex, see infra note 73). See Securities Exchange Act Release No. 59575 (March 13, 2009), 74 FR 11803 (March 19, 2009).

execution.<sup>60</sup> Specifically, for each of these stages in the life of an order, OTS requires the recording of the following information, as applicable, including but not limited to:

- for order receipt or origination,<sup>61</sup> the date and time the order is originated or received by a member or member organization; a unique order identifier; market participant symbol; and the material terms of the order;<sup>62</sup>
- for the internal or external routing of an order, the unique order identifier; the identification of the department to which an order was transmitted if transmitted internally; the date and time the order was received by the department receiving a transmitted order; the market participant symbol assigned to the member or member organization receiving the transmitted order or notation that the order was transmitted

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<sup>60</sup> See NYSE Rule 132B and NYSE Amex Equities Rule 132B. Each member or member organization shall, by the end of each business day, record each item of information required to be recorded under the rule in such electronic form as is prescribed by the NYSE (or NYSE Amex) from time to time. See NYSE Rule 132B(a)(3) and NYSE Amex Equities Rule 132B(a)(3). Members and member organizations shall be required to transmit to the NYSE or NYSE Amex, in such format as the applicable exchange may from time to time prescribe, such order tracking information as the exchange may request. See NYSE Rule 132C and NYSE Amex Equities Rule 132C.

<sup>61</sup> Members are also required to report: the identification of the department or terminal where an order is received directly from a customer; and where the order is originated by a member or member organization, the identification of the department (if appropriate) of the member that originated the order. See NYSE Rule 132B(b) and NYSE Amex Equities Rule 132B(b).

<sup>62</sup> The specific information required to be reported includes: number of shares; designation of the order as a buy or sell; designation of the order as a short sale; designation of the order as a market order, limit order, auction market order, stop order, auction stop order, or ISO; security symbol; limit or stop price; type of account; the date on which the order expires, and, if the time in force is less than one day, the time when the order expires; the time limit during which the order is in force; any request by a customer that an order not be displayed pursuant to Rule 604(c) under the Exchange Act; and special handling requests. See NYSE Rule 132B(b) and NYSE Amex Equities Rule 132B(b).

to a non-member;<sup>63</sup> the material terms of the order as transmitted;<sup>64</sup> and the date and time the order is transmitted; and

- for the modification or cancellation of an order, a new unique order identifier; the original unique order identifier; and the date and time a modification or cancellation was originated or received.<sup>65</sup>

Additionally, the NYSE and NYSE Amex require the recording of detailed information concerning the receipt, cancellation or execution of orders in NYSE and NYSE Amex-listed cash equity securities originated on or transmitted to the exchange floor.<sup>66</sup> Immediately following receipt of an order on the floor, the member receiving the order must record the following information: (1) the material terms of the order;<sup>67</sup> (2) a unique order identifier; (3) the clearing

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<sup>63</sup> The information required to be reported also includes whether the order was transmitted and received manually or electronically; the date the order was first originated or received by the transmitting member or member organization; and, for each order to be included in a bunched order, the bunched order route indicator assigned to the bunched order. See NYSE Rule 132B(c) and NYSE Amex Equities Rule 132B(c).

<sup>64</sup> The information required to be reported includes the number of shares to which the transmission applies. See NYSE Rule 132B(c) and NYSE Amex Equities Rule 132B(c).

<sup>65</sup> For cancellations or modifications, the following information also is required: the order identifier assigned to the order prior to modification; if the open balance of an order is canceled after a partial execution, the number of shares canceled; and whether the order was canceled on the instruction of a customer or the member or member organization. See NYSE Rule 132B(d) and NYSE Amex Equities Rule 132B(d).

<sup>66</sup> See NYSE Rule 123 and NYSE Amex Equities Rule 123, each of which require, among other things, a record of the cancellation of an order, which must include the time the cancellation was entered, and a record of the receipt of an execution report, which must include the time of receipt of the report.

<sup>67</sup> The specific information required includes the security symbol; quantity; side of the market; whether the order is a market, auction market, limit, stop, or auction limit order; any limit or stop price, discretionary price range, discretionary volume range, discretionary quote price, pegging ceiling price, pegging floor price and/or whether discretionary instructions are active in connection with interest displayed by other market centers; time in force; designation as held or not held; and any special conditions. See NYSE Rule 123(e) and NYSE Amex Equities Rule 123(e).

member organization and the identification of the member or member organization recording order details;<sup>68</sup> and (4) modification of terms of the order or cancellation of the order.<sup>69</sup>

Further, once an order is executed, the following information must be recorded: (1) the material terms of the execution;<sup>70</sup> (2) the unique order identifier; (3) the identity of the firms involved in the execution;<sup>71</sup> and (4) certain other information related to the execution.<sup>72</sup>

#### **E. Consolidated Options Audit Trail System**

In September 2000, the Commission instituted public administrative proceedings against Amex,<sup>73</sup> CBOE, the Pacific Exchange,<sup>74</sup> and the Philadelphia Stock Exchange<sup>75</sup> for

<sup>68</sup> The required information also includes the system-generated time of recording order details. See NYSE Rule 123(e) and NYSE Amex Equities Rule 123(e).

<sup>69</sup> See NYSE Rule 123(e) and NYSE Amex Equities Rule 123(e).

<sup>70</sup> The specific information required includes security symbol; quantity; transaction price; and execution time. See NYSE Rule 123(f) and NYSE Amex Equities Rule 123(f).

<sup>71</sup> The specific information required includes the executing broker badge number or alpha symbol; the contra side executing broker badge number or alpha symbol; the clearing firm number or alpha; and the contra side clearing firm number or alpha. See NYSE Rule 123(f) and NYSE Amex Equities Rule 123(f).

<sup>72</sup> The required information includes whether the account for which the order was executed was that of a member or member organization or non-member or non-member organization; the identification of member or member organization which recorded order details; the date the order was entered into an exchange system; an indication as to whether this is a modification to a previously submitted report; settlement instructions; special trade indication (if applicable); and the Online Comparison System control number. See NYSE Rule 123(f) and NYSE Amex Equities Rule 123(f).

<sup>73</sup> Amex was acquired by NYSE Euronext on October 1, 2008. Initially, the successor entity to Amex was established as NYSE Alternext U.S. LLC, but the name was changed in 2009 to NYSE Amex. See Securities Exchange Act Release No. 59575 (March 13, 2009), 74 FR 11803 (March 19, 2009).

<sup>74</sup> In 2001, the Archipelago Exchange LLC ("ArcaEx") was established as an electronic trading facility for Pacific Exchange's subsidiary PCX Equities, Inc. ("PCX Equities"). See Securities Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001). In 2005, Archipelago Holdings, Inc., the parent company of ArcaEx, acquired PCX Holdings, Inc., which included subsidiaries Pacific Exchange (PCX) and PCX Equities. See Securities Exchange Act Release No. 52497 (September 22, 2005), 70 FR 56949 (September 29, 2005). The NYSE merged with Archipelago

failing to uphold their obligations to enforce compliance with exchange rules and the federal securities laws, including those relating to reporting. Specifically, the Commission alleged that they had either conducted no automated surveillance, or inadequate automated surveillance; of trade reporting and consequently failed to adequately detect noncompliance with their rules.<sup>76</sup> In settling the Commission's enforcement action, the exchanges were required to jointly design and implement COATS to enable them to reconstruct markets promptly, surveil them, and enforce compliance with trade reporting, firm quote, order handling, and other rules.<sup>77</sup> The exchanges were required to complete this undertaking in five phases.<sup>78</sup>

In particular, each exchange was required to achieve the following through its audit trail: (1) synchronize trading and support system clocks with all other options exchanges; (2) design and implement a method to merge all options exchanges' reported and matched transaction data on a daily basis in a common computer format; (3) incorporate its quotations and the national best bid and offer as displayed in its market with the merged transaction data so that it could be promptly retrieved and merged in the common computer format with other options exchanges' merged transactions and quotation data; (4) design and implement an audit trail readily retrievable (in the common computer format) providing an accurate, time-sequenced record of electronic orders, quotations and transactions on such exchange, beginning with the receipt of an electronic order, and further documenting the life of the order through the process of execution,

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Holdings in 2006. See Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006). NYSE Arca is the successor to PCX.

<sup>75</sup> The Philadelphia Stock Exchange was acquired by The NASDAQ OMX Group, Inc. in 2008, and is now called NASDAQ OMX Phlx ("Phlx"). See Securities Exchange Act Release No. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008).

<sup>76</sup> See Options Settlement Order, supra note 15, at 12.

<sup>77</sup> Id. at 22.

<sup>78</sup> Id. at 22-25.

partial execution, or cancellation; (5) incorporate into the audit trail all non-electronic orders so that such orders were also subject to the audit trail requirements for electronic orders; and (6) design effective surveillance systems to use this newly available data to enforce the federal securities laws and the exchange's rules.<sup>79</sup>

The exchanges subject to the Options Settlement Order fully implemented the requirements in 2005. In addition, the International Securities Exchange, LLC ("ISE"), Boston Options Exchange Group, LLC ("BOX"), the Nasdaq Options Market ("NOM"), and BATS Options Exchange Market ("BATS Options") also comply with the COATS requirements.<sup>80</sup>

A majority of options exchanges require their members to provide the following information with respect to orders entered onto their exchange: (1) the material terms of the order;<sup>81</sup> (2) order receipt time;<sup>82</sup> (3) account type; (4) the time a modification is received; (5) the

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<sup>79</sup> See Options Settlement Order, *supra* note 15, at 22–25.

<sup>80</sup> See Securities Exchange Act Release Nos. 61154 (December 11, 2009), 74 FR 67278 (December 18, 2009), at 67280 (stating "ISE and the other options exchanges are required to populate a consolidated options audit trail ("COATS") system in order to surveil member activities across markets"); 61388 (January 20, 2010), 75 FR 4431 (January 27, 2010), at 4433 (Nasdaq OMX BX filing amending BOX's fee schedule, with similar language as Release No. 61154); and 61419 (January 26, 2010), 75 FR 5157 (February 1, 2010) (BATS Exchange, Inc. ("BATS") represented that BATS Options would comply with the specifications of COATS in submitting data to create a consolidated audit trail, as well as receiving COATS data for its own surveillance purposes).

<sup>81</sup> The specific information required includes option symbol; underlying security; expiration month; exercise price; contract volume; call/put; buy/sell; opening/closing transaction; price or price limit; and special instructions.

<sup>82</sup> The required information also includes identification of the terminal or individual completing the order ticket.

time a cancellation is received; (6) execution time; and (7) the clearing member identifier of the parties to the transaction.<sup>83</sup>

#### F. Other Audit Trail Requirements

SRO audit trail rules regarding information on orders for NMS stocks to be recorded by their members, and in some cases provided to the SRO, tend to be less uniform than SRO audit trail rules relating to listed options.<sup>84</sup> Some exchanges and FINRA have detailed audit trail data submission requirements for their members covering order entry, transmittal, and execution.<sup>85</sup> For example, the rules of one exchange require the recording of the following information for each order originating with an exchange participant that is given to or received from another participant for execution, transmitted by an exchange participant to another market, or originating off the exchange and transmitted to an exchange participant, and subsequent execution of any such orders:<sup>86</sup>

- information relating to receipt or transmission of the order, including the material terms of the order;<sup>87</sup> a unique order identifier; the identification of the clearing

<sup>83</sup> See e.g. BATS Rule 20.7; BOX Chapter V, Section 15; CBOE Chapter VI, Rules 6.24 and 6.51; NOM Rule Chapter V, Section 7; NYSE Amex Rules 153, Commentary .01, and 962; NYSE Arca Rules 6.67, 6.68, and 6.69; and Phlx Rules 1063 and 1080.

<sup>84</sup> For purposes of this release, the Commission does not consider SRO EBS rules to be audit trail rules.

<sup>85</sup> See Chicago Stock Exchange ("CHX") Article 11, Rule 3(b); FINRA Rules 7400 to 7470 (the OATS rules); Nasdaq Rules 6950 to 6958 (substantially similar to the OATS rules); BX Rules 6950 to 6958 (substantially similar to OATS rules); NYSE Rule 123 and 132B; and NYSE Amex Equities Rule 123 and 132B (OTS rules). See *supra* Sections I.C. and I.D. for a discussion of FINRA's OATS rules and the NYSE and NYSE Amex's OTS rules, respectively.

<sup>86</sup> See CHX Article 11, Rule 3(b).

<sup>87</sup> *Id.* The specific information required includes the symbol; number or shares or quantity of security; side of the market; order type; limit and/or stop price; whether the order is agency or proprietary; whether an order is a bona fide arbitrage order; whether the order is short; time in force; designation as held or not held; any special conditions or



participant and the participant recording the order details; the date and time of order receipt or transmission (if applicable); the market or participant to which the order was transmitted or from which the order was received (if applicable);

- information relating to modifications to or cancellation of the order, including any modifications to the order, any cancellation of all or part of the order; the date and time of receipt and transmission of any modifications to the order or cancellations; and the identification of the party canceling or modifying the order;<sup>88</sup>
- for executions of the order,<sup>89</sup> in whole or in part, the transaction price; the number of shares or quantity executed; the date and time of execution; the contra party to the execution; and any settlement instructions.<sup>90</sup>

The audit trail rules of the other exchanges incorporate only standard books and records requirements in accordance with Section 17 of the Exchange Act.<sup>91</sup>

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instructions (including any customer display instructions and any all-or-none conditions); and the date and time of any order expiration.

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Id.

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Id.

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Id. The participant also must record the system-generated times of recording this required information. This information must be recorded immediately after the information is received or becomes available. CHX Article 11, Rule 3(c). Additionally, before any such orders are executed, exchange participants must record the name or designation of the account for which the order is being executed. CHX Article 11, Rule 3(d). This rule does not apply to orders sent or received through the exchange's matching system or any other electronic systems the exchange recognizes as providing the required information in a format acceptable to the exchange. See CHX Article 11, Rule 3, Interpretations and Policies .03.

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See e.g. National Stock Exchange ("NSX") Chapter VI, Rule 4.1.; BATS Chapter IV, Rule 4.1.; CBOE Rule 15.1 (applicable to CBSX); ISE Stock Exchange Rule 1400; NYSE Arca Equities Rule 2.24; 15 U.S.C. 78q et seq. For example, one exchange only requires its members to make and keep books and records and other correspondence in conformity with Section 17 of the Exchange Act and the rules thereunder, with all other applicable laws and the rules, regulations and statements of policy promulgated thereunder, and with the exchange's rules. See NSX Chapter VI, Rule 4.1.

### G. Prior Commission Request for Comment

The Commission has previously requested comment regarding cross-market regulation, including whether changes should be made to existing audit trail rules, in two concept releases in 2003 and 2004.<sup>92</sup>

In 2003, the Commission sought public comment on a petition submitted by Nasdaq that raised concerns about the impact of market fragmentation on the trading in, and regulation of trading in, Nasdaq-listed securities.<sup>93</sup> Nasdaq, through OATS, collected data from its members trading Nasdaq-listed securities, which the NASD then used to surveil for potential rule violations.<sup>94</sup> Nasdaq requested that the Commission require all SROs trading Nasdaq-listed securities to implement an electronic audit trail identical to OATS.<sup>95</sup> Nasdaq also noted that the available cross-market audit trail information provided by the Intermarket Surveillance Group ("ISG")<sup>96</sup> was comprised of audit trail information from each of the exchanges and provided two

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<sup>92</sup> See Securities Exchange Act Release Nos. 47849 (May 14, 2003), 68 FR 27722 (May 20, 2003) (File No. S7-11-03) ("Intermarket Trading Concept Release") and 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004) (File No. S7-40-04) ("Concept Release Concerning Self-Regulation").

<sup>93</sup> See letter to Jonathan G. Katz, Secretary, Commission, from Edward Knight, Executive Vice President and General Counsel, Nasdaq, dated April 11, 2003 (File No. 4-479) ("Nasdaq Petition"). In particular, Nasdaq was concerned over what it deemed "unequal and inadequate regulation" by other markets trading Nasdaq-listed securities. *Id.* at 2. See also Intermarket Trading Concept Release, *supra* note 92, at 27223.

<sup>94</sup> See Nasdaq Petition, *supra* note 93, at 10, and Intermarket Trading Concept Release, *supra* note 92, at 27224.

<sup>95</sup> See Nasdaq Petition, *supra* note 93, at 11, and Intermarket Trading Concept Release, *supra* note 92, at 27224.

<sup>96</sup> The ISG was created in 1983 and its members include all of the registered national securities exchanges and FINRA. ISG states that its goals are to enhance intermarket surveillance, assure the integrity of trading, and provide investor protection. To achieve these goals, ISG members share data such as audit trail information and short interest data among themselves. ISG provides surveillance tools to supplement its participant members' existing surveillance systems, such as the ISG Unusual Activity Report and the Consolidated Equity Audit Trail. These reports are made available from SIAC to

day delayed data at the clearing firm level, with time data from non-synchronized clocks.<sup>97</sup>

Nasdaq believed that the information provided by ISG was insufficient to identify potentially violative activity.<sup>98</sup>

In response to the Intermarket Trading Concept Release, the Commission received a variety of comments on intermarket surveillance and order audit trail issues.<sup>99</sup> Of those

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members of ISG and are intended to provide a consolidated view across all markets of trade, quote, and clearing activity. See comment letter from Brian F. Colby, Chairman, Intermarket Surveillance Group, to Jonathan G. Katz, Secretary, Commission, dated June 18, 2003 (“ISG 2003 Comment Letter”) (commenting in response to the Intermarket Trading Concept Release).

<sup>97</sup> See Nasdaq Petition, supra note 93, at 10, and Intermarket Trading Concept Release, supra note 92, at 27224.

<sup>98</sup> See Nasdaq Petition, supra note 93, at 10–11, and Intermarket Trading Concept Release, supra note 92, at 27224.

<sup>99</sup> See comment letters from Darla C. Stuckey, Corporate Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated June 19, 2003 (“NYSE Comment Letter”); Jeffrey T. Brown, General Counsel, Cincinnati Stock Exchange, to Jonathan G. Katz, Secretary, Commission, dated June 19, 2003 (“CSE Comment Letter”); Michael J. Simon, Senior Vice President and Secretary, International Securities Exchange, Inc., to Jonathan G. Katz, Secretary, Commission, dated June 19, 2003 (“ISE Comment Letter”); William O’Brien, Chief Operating Officer, Brut, LLC, to Jonathan G. Katz, Secretary, Commission, dated June 19, 2003 (“Brut Comment Letter”); Kim Bang, President, Bloomberg Tradebook LLC, to Jonathan G. Katz, Secretary, Commission, dated June 20, 2003 (“Bloomberg Tradebook Comment Letter”); Donald D. Kittell, Executive Vice President, Securities Industry Association, to Jonathan G. Katz, Secretary, Commission, dated June 27, 2003 (“SIA Comment Letter”); Edward J. Joyce, President and Chief Operating Officer, CBOE, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2003 (“CBOE Comment Letter”); W. Hardy Callcott, Senior Vice President and General Counsel, Charles Schwab & Co., Inc., to Jonathan G. Katz, Secretary, Commission, dated July 7, 2003 (“Schwab Comment Letter”); Richard Ketchum, General Counsel, Citigroup, to Jonathan G. Katz, Secretary, Commission, dated July 8, 2003 (“Citigroup Comment Letter”); John S. Markle, Associate General Counsel, Ameritrade Holding Corp., to Jonathan G. Katz, Secretary, Commission, dated July 10, 2003 (“Ameritrade Comment Letter”); and Eric Schwartz, Managing Director, Goldman Sachs, and Duncan Niederauer, Co-Chief Executive Officer, Spear, Leeds & Kellogg, to Jonathan G. Katz, Secretary, Commission, dated July 25, 2003 (“Goldman Sachs and Spear, Leeds & Kellogg Comment Letter”).

commenters that addressed the general concept of creating a uniform electronic audit trail, some supported the concept while others did not.<sup>100</sup>

One commenter expressed the view that once broker-dealers have implemented systems necessary to comply with audit trail requirements, it would not be incrementally significant from a cost perspective to supply the same data in a common format to additional SROs, but that there would be a significant cost if the data to be captured and the methods of encoding and delivering the data differed from market to market.<sup>101</sup> This commenter urged the Commission, if it were to require all market centers to adopt audit trail requirements, to ensure that the requirements are uniform and standardized. This commenter recommended a single standard for real time electronic trade and audit trail reporting, which would be applicable to all equity securities traded in the national market regardless of where listed or traded, and where data would be captured in a central depository, aggregated and made immediately available to each relevant market center,

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<sup>100</sup> Of the commenters that clearly commented on the creation of a uniform intermarket audit trail, Citigroup and Goldman Sachs and Spear, Leeds & Kellogg were in favor of the idea, and Bloomberg supported a consolidated audit trail for those SROs trading Nasdaq-listed securities. See Citigroup Comment Letter, *supra* note 99, at 6; Goldman Sachs and Spear, Leeds & Kellogg Comment Letter, *supra* note 99, at 3-4; and Bloomberg Tradebook Comment Letter, *supra* note 99, at 3. Brut, CBOE, and the NYSE did not appear to be in favor of a standardized intermarket audit trail. See Brut Comment Letter, *supra* note 99, at 5 (arguing for addressing improvements to surveillances falling short of Exchange Act requirements individually instead of "costly and comprehensive technology overhauls"); CBOE Comment Letter, *supra* note 99, at 2 (explaining that it "supports expanding the use of existing tools and enhancing [SRO] and Commission coordination to strengthen surveillance and to achieve more uniform regulation..." and noting that the Commission could "play a significant role in achieving uniform SRO regulation [by] establishing guiding principles on a variety of areas that affect all SROs." CBOE also noted that there should be enhanced coordination of SRO regulatory efforts through ISG and through 17d-2 agreements); and NYSE Comment Letter, *supra* note 99, at 5 (suggesting linking SRO audit trails in the manner of the ISG Consolidated Audit Trail).

<sup>101</sup> See Goldman Sachs and Spear, Leeds & Kellogg Comment Letter, *supra* note 99, at 3.

possibly through direct electronic data feeds.<sup>102</sup> Likewise, another commenter stated that it would be preferable for there to be one uniform audit trail system, rather than each SRO adopting its own audit trail requirements and systems, to reduce the potential for conflicting rules and regulations and duplicative systems and technology requirements.<sup>103</sup> Another commenter recommended that if the Commission determined that the need for a particular SRO to have enhanced audit trail information outweighs costs to member firms, SROs be required to coordinate efforts so as to reduce duplication of systems and regulatory efforts.<sup>104</sup>

Several commenters urged the Commission to consider the costs to broker-dealer firms of supplying the audit trail data when considering the appropriateness of extending OATS-like audit trail requirements to other market centers.<sup>105</sup> One commenter stated the belief that firms already are required to maintain all of the customer and transaction information that regulators would want under their current books and records requirements and that most firms do not believe there is a justification for requiring firms to spend the money necessary to send this information to

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<sup>102</sup> Id at 4.

<sup>103</sup> See Citigroup Comment Letter, supra note 99, at 6.

<sup>104</sup> See SIA Comment Letter, supra note 99, at 4. One commenter agreed that the Commission would be justified in requiring all SROs trading Nasdaq-listed securities to coordinate electronic audit trail systems with the NASD. See Bloomberg Tradebook Comment Letter, supra note 99. On the other hand, one commenter stated its belief that if there is a legitimate need to improve on the ISG audit trail, the markets should act jointly to do so, without being forced to adopt Nasdaq's proprietary audit trail. See ISE Comment Letter, supra note 99.

<sup>105</sup> See SIA Comment Letter, supra note 99, at 4; Goldman Sachs and Spear, Leeds & Kellogg Comment Letter, supra note 99, at 3 (stating that any decision about extending OATS to other markets should take into account the costs imposed on SROs, market intermediaries and the markets); and Ameritrade Comment Letter, supra note 99, at 3.

every market center where an order may be routed.<sup>106</sup> Another commenter was concerned about the impact on each individual market's structure of mandating uniformity.<sup>107</sup>

Some commenters supported the ISG as a facilitator of a coordinated regulation.<sup>108</sup> One commenter noted that the ISG Consolidated Equity Audit Trail was a valuable supplement to existing SRO market data.<sup>109</sup> One commenter also endorsed the ISG audit trail as well as CSE's Firm Order Submission system,<sup>110</sup> stating that it was preferable to enhance these systems rather than conduct a "mass migration" to OATS.<sup>111</sup> The ISG itself stated that no other market had reported any problems with ISG's timing of the incorporation of the clearing data into the Consolidated Equity Audit Trail, nor with the delivery of its audit trail information.<sup>112</sup>

In 2004, in a release seeking comment on a variety of issues relating to self-regulation,

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<sup>106</sup> See SIA Comment Letter, supra note 99, at 4.

<sup>107</sup> See CSE Comment Letter, supra note 99, at 6-7 (noting that the data formats among exchanges may vary due to structural needs and system designs; thus, while this commenter advocated that exchanges should be required to have internal audit trails tracking orders from inception to execution, it argued that design flexibility be maintained so that exchanges could create the audit trail systems best suited to monitor their markets).

<sup>108</sup> See Ameritrade Comment Letter, supra note 99, at 2; CSE Comment Letter, supra note 99, at 13; ISE Comment Letter, supra note 99, at 4; and NYSE Comment Letter, supra note 99, at 3.

<sup>109</sup> See NYSE Comment Letter, supra note 99.

<sup>110</sup> In its comment letter, CSE stated that its Firm Order Submission system ("FOS") was more comprehensive than OATS and that the exchange had pioneered order audit trail development. See CSE Comment Letter, supra note 99. In its petition, Nasdaq argued that FOS was used voluntarily for settling commercial disputes between traders and was not the meant for surveillance. See Nasdaq Petition, supra note 93, at 4.

<sup>111</sup> See Brut Comment Letter, supra note 99, at 6.

<sup>112</sup> See ISG 2003 Comment Letter, supra note 99.

the Commission again sought public comment on intermarket surveillance.<sup>113</sup> The Commission discussed the individual audit trails developed by several equity markets, COATS, and ISG's clearing level audit trail.<sup>114</sup> The Commission suggested that a more robust intermarket order audit trail for options and equity markets could enhance the surveillance of order flow and requested comment on the issue.<sup>115</sup>

One commenter on the Concept Release Concerning Self-Regulation stated that, because trading in most liquid securities now occurs on multiple markets, no single SRO could capture a complete picture of all the trading in each product, all trading by one broker-dealer, and even all the trading related to a single order.<sup>116</sup> This commenter stated its belief that the lack of uniform order and transaction data creates regulatory gaps and may provide incentives for market participants to conduct activities on markets where less regulatory data is collected on an automated basis.<sup>117</sup> This commenter believed that minimum data-collection standards should be required to ensure adequate regulation across all markets, and that consolidating that data would permit effective intermarket regulation while ensuring that no single market has a competitive advantage.<sup>118</sup>

Another commenter gave an example of how it believed the lack of real time reporting across markets was detrimental to surveillances relating to certain illegal activities. This

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<sup>113</sup> See Concept Release Concerning Self-Regulation, supra note 92, at Sections IV.C and V.A.2.

<sup>114</sup> Id.

<sup>115</sup> Id. at 71277.

<sup>116</sup> See comment letter from Robert R. Glauber, Chairman and Chief Executive Officer, NASD, to Jonathan G. Katz, Secretary, Commission, dated March 15, 2005 ("NASD Comment Letter"), at 10.

<sup>117</sup> Id. at 11.

<sup>118</sup> Id.

commenter stated its belief that “effective surveillances relating to insider trading, market manipulation and stock or options frontrunning in multiple markets can be hindered because away-market data such as order information, position limit reports and large position reports (for options) are not available electronically on a real time or near real time basis to the SRO that has generated an alert or flag in the course of its routine surveillance.”<sup>119</sup> This commenter suggested that consolidating this type of data in real time or near real time would permit SROs to immediately detect and review all aberrational activity in the multiple market centers, which could significantly deter or prevent violative conduct.<sup>120</sup>

Another commenter stated its belief that the lack of a coordinated surveillance system is potentially one of the more significant problems facing the markets, and that as trading strategies become more sophisticated across multiple markets and national borders, the potential for sophisticated fraud also increases.<sup>121</sup> One commenter recommended a consolidated information base that all regulators could access, stating that “having separate and uncoordinated regulatory data is inefficient and detracts from the quality of regulation.”<sup>122</sup> Further, another commenter suggested a voluntary regulatory cooperative, jointly owned by participant exchanges, that would be the central regulator for surveillance, investigations and examinations and would include an electronic interface with the SEC; this commenter believed that the costs of developing an

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<sup>119</sup> See comment letter from Mary Yeager, Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005, at 8.

<sup>120</sup> Id.

<sup>121</sup> See comment letter from Rebecca T. McEnally, Director, and Linda L. Rittenhouse, Senior Policy Analyst, Centre for Financial Market Integrity, to Nancy M. Morris, Secretary, Commission, dated July 14, 2006, at 6.

<sup>122</sup> See comment letter from Kim Bang, Chief Executive Officer, Bloomberg L.P., to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005, at 4.



intermarket consolidated order audit trail system should be justified by the regulatory value of the data to be captured.<sup>123</sup>

## II. Basis for Proposed Rule

As noted above, the U.S. securities markets have experienced a dynamic transformation in recent years. Rapid technological advances and regulatory developments have produced fundamental changes in the structure of the securities markets, the types of market participants, the trading strategies employed, and the array of products traded. Trading of securities has become more dispersed among exchanges and various other trading venues, including the OTC market. The markets have become even more competitive, with exchanges and other trading centers aggressively competing for order flow by offering innovative order types, new data products and other services, and through fees charged or rebates provided by the markets. The Commission preliminarily believes that with today's fast, electronic and interconnected markets, there is a heightened need for a single uniform electronic cross-market order and execution tracking system that includes more information than is captured by the existing SRO audit trails, and in a uniform format. Such a system would enable SROs to better fulfill their regulatory responsibilities to monitor for and investigate illegal activity in their markets and by their members. Further, the Commission preliminarily believes that such a system would enable the Commission staff to better carry out its oversight of the NMS for securities and to perform market analysis in a more timely fashion, whether on one market or across markets.

Each national securities exchange and national securities association must be organized and have the capacity to comply, and enforce compliance by its members, with its rules, and with

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<sup>123</sup> See comment letter from Meyer S. Frucher, Chairman and Chief Executive Officer, Philadelphia Stock Exchange, to Jonathan G. Katz, Secretary, Commission, dated March 9, 2005, at 3.

the federal securities laws, rules, and regulations.<sup>124</sup> The Commission preliminarily believes that the exchanges and FINRA could more effectively and efficiently fulfill these statutory obligations if the SROs had direct, electronic real time access to consolidated and more detailed order and execution information across all markets.<sup>125</sup> Likewise, the Commission has the statutory obligation to oversee the exchanges and associations,<sup>126</sup> and to enforce compliance by the members of exchanges and associations with the respective exchange's or association's rules, and the federal securities laws and regulations.<sup>127</sup> The Commission also preliminarily believes that electronic real time access to consolidated information and more detailed cross market order and execution information also would aid the Commission in carrying out its statutory obligations.

Section 11A(a)(3)(B) of the Exchange Act provides in part that the Commission may, by rule, require SROs to act jointly with respect to matters as to which they share authority under the Exchange Act in regulating a NMS for securities.<sup>128</sup> Pursuant to this authority, the Commission today is proposing a rule that would require all national securities exchanges and national securities associations to jointly submit to the Commission an NMS plan to create, implement, and maintain a consolidated audit trail that would be more comprehensive than any

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<sup>124</sup> See, e.g., Sections 6(b)(1), 19(g)(1) and 15A(b)(2) of the Exchange Act, 15 U.S.C. 78f(b)(1), 78s(g)(1), and 78o-3(b)(2).

<sup>125</sup> The Commission notes that, if adopted as proposed, its Large Trader Proposal would not amend or impact the scope of any of the existing SRO audit trail rules. See Large Trader Proposal, *supra* note 11.

<sup>126</sup> See, e.g., Sections 2, 6(b), 15A(b), and 19(h)(1) of the Exchange Act, 15 U.S.C. 78b, 15 U.S.C. 78f(b), 15 U.S.C. 78o-3(b), and 15 U.S.C. 78s(h)(1).

<sup>127</sup> See, e.g., 19(h)(1) of the Exchange Act, 15 U.S.C. 78s(h)(1).

<sup>128</sup> See Section 11A(a)(3)(B) of the Exchange Act, 15 U.S.C. 78k-1(a)(3)(B).

audit trail currently in existence.<sup>129</sup> The proposed Rule would require the consolidated audit trail to capture certain information about each order for an NMS security, including the identity of the customer placing the order and the routing, modification, cancellation or execution of the order, in real time. In effect, the proposal would create a time-stamped “electronic audit trail record or report” for every order, and each market participant that touches the order would be required to report information about certain reportable events, such as routing or execution of the order.

The Commission preliminarily believes that a consolidated order audit trail, such as the one proposed today, could enhance the ability of the SROs to carry out their obligations to regulate their markets and their members. The Commission also preliminarily believes that the proposed consolidated order audit trail could aid the Commission in fulfilling its statutory obligations to oversee SROs,<sup>130</sup> monitor for the manipulation of security prices,<sup>131</sup> and detect the use of manipulative or deceptive devices in the purchase or sale of a security,<sup>132</sup> as well as to perform market reconstructions.

The Commission preliminarily believes that proposed Rule 613 would benefit the industry, through potential cost reductions, by eliminating the need for certain SRO and Commission rules that currently mandate the collection and provision of information, at least with respect to NMS securities.<sup>133</sup> The Commission also preliminarily believes that the proposal

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<sup>129</sup> See infra Section III for a description of proposed Rule 613.

<sup>130</sup> See, e.g., Sections 6(b)(1) and 19(h) of the Exchange Act, 15 U.S.C. 78f(b)(1) and 78s(h).

<sup>131</sup> See Section 9 of the Exchange Act, 15 U.S.C. 78i.

<sup>132</sup> See Section 10 of the Exchange Act, 15 U.S.C. 78j.

<sup>133</sup> See infra Section VI.A (discussion of benefits of the proposed Rule).

would benefit SROs, as well as the NMS for NMS securities, by ultimately reducing some regulatory costs, which may result in a more effective re-allocation of overall costs.<sup>134</sup>

The Commission recognizes that SRO rules requiring members to capture and disclose audit trail information already exist, and considered whether more modest improvements to existing rules, and corresponding SRO and member systems, would achieve the proposed Rule's objective at lower cost. For example, the Commission considered whether to standardize and expand the order information collected by existing audit trails, the EBS system, Rule 17a-25 and equity cleared reports. Without centralization of the trading data in a uniform electronic format, however, the Commission's goals of cross-market comparability and ready access could not be achieved. Additionally, this approach would not resolve concerns over how long it takes to obtain order and execution information because the data is often not available in real time and is provided only upon request.<sup>135</sup> Similarly, the Commission considered whether assuring access to existing audit trails to other SROs and the Commission would sufficiently advance its goals. Even if SROs could view order activity on a real time basis on other exchanges, this would not eliminate the need for SROs to check multiple repositories to view and obtain order information. Moreover, the information may be captured, stored and displayed in a variety of formats, making comparisons more difficult. The Commission, therefore, preliminarily does not believe that "retrofitting" existing rules and systems would be a more effective way to achieve the goals of the proposed consolidated audit trail than having the requirements contained in a single Commission rule, and a single NMS plan.

As discussed below, the Commission preliminarily believes that existing audit trails are limited in their scope and effectiveness in varying ways. SRO and Commission staff also

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<sup>134</sup>

Id.

<sup>135</sup>

See infra note 149.

currently obtain information about orders or trades through the EBS system, Rule 17a-25,<sup>136</sup> and from equity cleared reports.<sup>137</sup> However, as discussed below, the information provided pursuant to the EBS system, Rule 17a-25, and the equity cleared reports also is limited, to varying degrees, in detail and scope.

**A. Lack of Uniformity of, and Gaps in, Current Required Audit Trail Information**

As noted above, the type of information relating to orders and executions currently collected by the exchanges and FINRA differs widely. For example, FINRA's OATS rules and NYSE/NYSE Amex's OTS rules (as supplemented by the requirements of NYSE and NYSE Amex Rule 123) both set forth in relative detail the information required to be recorded by a FINRA, NYSE or NYSE Amex member upon receipt or origination of an order; following transmission of an order to another FINRA, NYSE or NYSE Amex member; and following modification, cancellation or execution of such order.<sup>138</sup> In contrast, some other exchanges' rules only require their members to keep records in compliance with the member's recordkeeping obligations under Section 17(a) of the Exchange Act and rules thereunder,<sup>139</sup> rather than requiring that specific information be captured for orders sent to and executed on the exchange.<sup>140</sup> Although Rule 17a-3 under the Exchange Act<sup>141</sup> requires that a member make and keep detailed information with respect to each brokerage order, it does not, for instance, require

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<sup>136</sup> 17 CFR 240.17a-25.

<sup>137</sup> See supra Sections I.A. and I.B. for a description of the EBS system, Rule 17a-25, and equity cleared reports.

<sup>138</sup> See FINRA Rules 7400 through 7470, NYSE Rules 123 and 132B, NYSE Amex Equities Rule 123 and 132B, and supra Sections I.C. and I.D. See also CHX Article II, Rule 3; Nasdaq Rules 6950 to 6958; and BX Rules 6950 to 6958.

<sup>139</sup> 15 U.S.C. 78q(a).

<sup>140</sup> See, e.g., NSX Rules 4.1 and 4.2, NYSE Arca Equities Rule 9.17, and BATS Rule 4.1.

<sup>141</sup> 17 CFR 240.17a-3.

information with respect to the routing of the order, or that each order be assigned a unique order identifier.<sup>142</sup> Similarly, the scope of securities covered by existing audit trail rules also differs among the exchanges and FINRA. FINRA's OATS rules, for instance, apply to orders for equity securities listed on Nasdaq and OTC securities, while OTS captures information for orders in NYSE and NYSE Amex-listed cash equity securities.<sup>143</sup>

While there is no current requirement that all SROs record the same information for orders and executions in the same or different securities, each SRO has a statutory obligation to regulate its market and its members. The Commission is concerned that the lack of uniformity as to the type of audit trail information gathered by the different exchanges and FINRA, and the lack of compatibility in the format of each SRO's audit trail data, may hinder the ability of SRO and Commission staff to effectively and efficiently monitor for, detect, and deter illegal trading that occurs across markets. If a market participant is engaging in manipulative behavior across various markets, but the rules of one market do not require its members to provide detailed information regarding the orders sent to its market, it may be difficult for regulators to determine that trading activity on one market was related to trading activity on another market. For

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<sup>142</sup> Rule 17a-3(a)(6)(i) under the Exchange Act requires that a member keep a memorandum of each brokerage order given or received for the purchase or sale of securities, whether executed or not, showing the terms and conditions of the order and any modification or cancellation thereof; the account for which it was entered; the time the order was received; the time of entry; the execution price; the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer, or, if a customer entered the order on an electronic system, a notation of that entry; and, to the extent feasible, the time of execution or cancellation. See 17 CFR 240.17a-3(a)(6)(i).

<sup>143</sup> See supra Sections I.C. and I.D. See also supra the discussion in the introduction to Section II relating to the Commission's consideration of whether "retrofitting" existing SRO audit trail rules and systems would achieve the goals of the proposed consolidated audit trail.

example, Section 9 of the Exchange Act expressly prohibits "wash sales."<sup>144</sup> A trader could attempt to disguise such trading by executing various legs of wash transactions on different markets. Individual market surveillance based on individual SRO audit trail data would not always be able to detect this kind of cross-market abuse.

Further, while current order audit trail rules provide a framework for capturing order information, the Commission is concerned that certain information about orders and executions that would be useful to efficient and effective regulation of inter-market trading activity and prevention of manipulative practices is not captured by existing audit trails. Most importantly, the existing audit trails do not require members to provide information identifying the customer submitting an order, the person with investment discretion for the order, or the beneficial owner. The identity of this "ultimate customer," however, often is necessary to tie together potential manipulative activity that occurs across markets and through multiple accounts at various broker-dealers. While the Commission notes that exchange and FINRA regulatory staff, as well as Commission staff, eventually can obtain identifying customer or beneficial account information by submitting requests for information through ISG or to various broker-dealers involved in potentially wrongful activities, this process can result in significant delays in investigating market anomalies or potentially manipulative behavior. The Commission preliminarily believes that gaps such as this in required audit trail information may hinder the ability of regulatory authorities to enforce compliance with SRO rules and the federal securities laws, rules, and regulations in a timely manner.

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<sup>144</sup> See Section 9(a)(1) of the Exchange Act, 15 U.S.C. 78i(a)(1). Wash sales are transactions involving no change in beneficial ownership. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 205 n. 25 (1976).

In addition, an exchange's audit trail information effectively ends when an order is routed to another exchange. For example, although the NYSE's OTS rule requires a NYSE member or member organization to record the fact that an order was transmitted to a non-member, the rules do not require the recording of what subsequently happens to the order.<sup>145</sup> Likewise, FINRA's OATS data collection effectively ends if an order is routed from a member of FINRA to an exchange.<sup>146</sup> As a result, key pieces of information about the life of an order may not be captured, or easily tracked, if an order is routed from one exchange to another, or from one broker-dealer to an exchange. For example, the name, or identifier, of a broker-dealer that initially received an order may be captured by the audit trail of the exchange of which that broker-dealer is a member when the broker-dealer sends the order to the exchange. However, if the order is routed to and executed on a second exchange, the identifying information for that initial broker-dealer may not be captured by the second exchange's audit trail requirements.

Similarly, under current audit trail rules, an incoming order may be assigned an order identifier by the initial receiving exchange; however, if the order is routed to a second exchange, there is no requirement that this order identifier be passed along to or maintained by the second exchange. Thus, one order that is routed across markets can have multiple order identifiers, each unique to one exchange. The Commission preliminarily believes that, from a regulatory standpoint, the lack of standardized cross-market order identifiers can pose significant obstacles and delays in effectively detecting and deterring manipulative behavior because SRO and Commission staff cannot readily collect the necessary data (that is, they cannot readily piece

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<sup>145</sup> See NYSE Rule 132B(c)(3).

<sup>146</sup> See FINRA Rule 7440(c)(6). The Commission understands that FINRA is able to link OATS order information to Nasdaq order and execution data.



together activity related to the same order or the same customer occurring across several markets) to determine whether violative behavior has occurred.

Additionally, the Commission is concerned that the data generated by the EBS system or that is available through the equity cleared reports also lacks items of information needed to match up order and trade information across markets to fully understand a particular trading pattern or to reconstruct a certain type of trading activity. EBS data does not include the time of execution, and often does not include the identity of the beneficial owner.<sup>147</sup> The equity cleared data also lacks the time of execution, as well as time of order receipt, often the identity of the beneficial owner, the identity of the broker-dealer(s) that received and/or executed the order (if different from the clearing broker-dealer), and short sale borrow and fails information. In order to obtain the time an order was received or the identity of the beneficial owner, therefore, SRO or Commission staff may take the additional step of submitting an electronically generated blue sheet request to the clearing broker-dealer identified in the equity cleared report to ask that broker-dealer to identify the beneficial ownership of the account(s) effecting the relevant transactions and/or the introducing broker,<sup>148</sup> and this may take a few steps if the clearing broker-dealer does not know the introducing broker, but only the executing broker (if different). If the beneficial ownership of the account(s) was not specified in the clearing broker-dealer's response, the staff could then ask the introducing broker-dealer for the time an order was received and the beneficial account holder information. Often, additional steps are required to identify the beneficial account holder, such as when the "customer" is an omnibus account. Furthermore, the

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<sup>147</sup> If a customer has an account directly with a clearing firm, or if an introducing firm clears its customers' transactions on a fully disclosed basis with the clearing firm, the clearing firm should be able to identify the beneficial owner of the account on its EBS response.

<sup>148</sup> For purposes of this discussion, introducing broker means the broker-dealer that received or originated the order, and that is not also the clearing broker.

equity cleared data could be duplicative. For example, one side of a trade can appear multiple times in the equity cleared reports because it may be reported by a specialist, a clearing broker-dealer, and the broker-dealer holding the customer's allocation account and the customer's trading account.

The lack of cohesive, readily available order and execution information creates significant hurdles for investigators at both the SROs and at the Commission. In order for SROs to investigate potential violations of their rules and the federal securities laws and rules by their members, the SROs should have the ability to analyze the activities of their members taking place across different market centers. This requires the accumulation and interpretation of data from numerous, disparate sources sometimes presenting inconsistent information. Similarly, the experience of the Commission staff shows that the lack of a consolidated audit trail results in the investment of significant resources to investigate potential market abuses. For example, when investigating potential insider trading and other market manipulations, Commission staff first obtains an equity cleared report to identify the clearing broker-dealers for trades involving the stock under investigation and the trading volume for a particular period of time. Then staff sends document requests to those clearing broker-dealers to identify the broker-dealers that executed trades in the stock over that period of time. This process can be complicated further by potential market manipulators that trade through small introducing brokers or use offshore corporate accounts and prime brokerage or other arrangements to conduct transactions. Commission staff also may request trade data for additional time periods identified during the course of the investigation, resulting in further delays. Commission staff thus often must make multiple requests to broker-dealers to obtain sufficient order information about the purchase or sale of a specific security to be able to adequately analyze trading. These multiple requests and responses

can take a significant amount of time and delay the Commission's efforts to analyze the data on an expedited basis.<sup>149</sup> While the investigative protocols of each SRO may differ from those used by the Commission, in each case, collecting, interpreting and analyzing diverse data sources is labor intensive and time consuming.

The Commission is concerned that inadequacies in the current audit trail rules, EBS system, and equity cleared reports also impede the ability of SRO or Commission staff to promptly analyze trading patterns, particularly to prepare market reconstructions. For example, if Commission staff wants to undertake an analysis of an extreme market movement over a limited period of time, Commission staff would need to analyze audit trail information and EBS submissions of trading data to determine if specific trading strategies, techniques or participants appeared to be associated with the movement. Because of difficulties in linking trades in the audit trails with aggregate day-end trading data in EBS submissions, conducting this analysis is difficult and time-consuming. While the audit trail data could identify the precise execution times of trades by particular clearing broker-dealers, it would not identify the specific customers or beneficial owners involved in the trades. On the other hand, while EBS submissions provide summary trading information for particular accounts at the clearing broker-dealers, they lack execution times for these trades. Further complications can arise due to the common practice for large traders to route their orders through multiple accounts at multiple clearing firms, as well as practices at some firms that use "average price accounts" to effect trades that are eventually settled in multiple proprietary and/or customer accounts. While these practices are not, in

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<sup>149</sup> Rule 17a-25 (as well as the SRO EBS rules) does not specify a definitive deadline by which such information must be furnished to the Commission and, in the Commission's experience, data collected through the EBS system often is subject to lengthy delays, particularly with respect to files involving a large number of transactions over an extended period of time.

themselves, improper, their use makes it more challenging to establish with certainty when trading on behalf of a particular trader was effected during the trading session.

The Commission preliminarily believes that the proposed consolidated audit trail would help alleviate the difficulties faced by Commission staff in performing market reconstructions, such as those described in the above example, by requiring that national securities exchanges, national securities associations, and their members provide order and execution data to one central location, largely on a real time basis, in a uniform electronic format. Having this information readily available in a central location would reduce the need for staff to request and collect such information from multiple broker-dealers and then examine, analyze and reconcile the disparate information provided to accurately "reconstruct" the market.<sup>150</sup>

#### **B. Books and Records Requirements**

Because brokers-dealers often are members of several exchanges and FINRA, they are subject to and must comply with the differing audit trail rules. Brokers and dealers also have a statutory obligation to maintain records in compliance with Commission and SRO rules.<sup>151</sup> As a result of the differing audit trail rules, brokers and dealers may be required to keep records to

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<sup>150</sup> As discussed, the Commission preliminarily believes that the proposal would improve the ability of regulators to conduct timely and accurate trading analyses for market reconstructions and complex investigations, as well as inspections and examinations. Indeed, the Commission believes that the proposed consolidated audit trail, if implemented, would have significantly enhanced the Commission's ability to quickly reconstruct and analyze the severe market disruption that occurred on May 6, 2010. If approved and implemented, the proposal also would enhance the Commission's ability to similarly respond to future severe market events.

<sup>151</sup> See Section 17(a)(1) of the Exchange Act, 15 U.S.C. 78q(a)(1), and Rules 17a-3 and 17a-4 under the Exchange Act, 17 CFR 240.17a-3 and 17a-4.

comply with each audit trail rule relating to trading in a certain security. Thus, some broker-dealers may now face significant costs to comply with varying audit trail rules.<sup>152</sup>

### C. Time Lags

Current audit trail rules require that an SRO's members submit order and execution information by the end of each business day (in the case of OATS), or in certain cases, upon request by the regulating entity (for instance, like OTS).<sup>153</sup> End-of-day or upon request reporting, by definition, limits regulators' ability to carry out real time cross-market surveillance and investigations of market anomalies. The Commission preliminarily believes that end-of-day reporting, coupled with the current laborious process of identifying the ultimate customer responsible for a particular securities transaction that may take several days, weeks or even months, can impact effective oversight by hindering the ability of SRO regulatory staff to identify manipulative activity close in time to when it is occurring, and respond to instances of potential manipulation quickly. This process also hinders the Commission's ability to detect and investigate potentially manipulative behavior. Manipulative activity by some market participants can result in other market participants, such as retail investors, losing money. The longer that manipulative behavior goes undetected over time, the greater the potential harm to investors. Further, timely pursuit of potential violations can be important in seeking to freeze and recover any profits received from illegal activity.

### D. Access to Audit Trail Information

While each SRO has direct access to audit trail information received from its members, as well as its own data relating to orders received and executed on its market, one SRO cannot

<sup>152</sup> See Goldman Sachs and Spear, Leeds & Kellogg Comment Letter, supra note 99, at 3, and SIA Comment Letter, supra note 99, at 3 (each commenting on the Nasdaq Petition and Intermarket Trading Concept Release).

<sup>153</sup> See supra Sections I.C. and I.D.

directly or easily access the audit trail information collected by other SROs, despite the interconnectedness of today's securities markets and the fact that orders are often routed from one marketplace to another marketplace for execution. In addition, Commission staff itself does not have immediate access to the exchanges' and FINRA's audit trail information, and instead must specifically request that an exchange or FINRA produce its audit trail information.<sup>154</sup>

The Commission notes that ISG provides a framework for the voluntary sharing of information and coordination of regulatory efforts among the exchanges and FINRA to address potential intermarket manipulations and trading abuses. The Commission believes that ISG plays an important role in information sharing among markets that trade the same securities, as well as related securities or futures on the same products.<sup>155</sup> However, the information provided to ISG, which is drawn from each individual exchange's audit trail and books and records, is not in any uniform or comparable format. In addition, information is only submitted to ISG upon a request by one of its members, and the information is not provided by ISG members in real time. Further, the operation of ISG is not subject to the Commission's oversight, including approval of what, and how, information is collected from and shared across SROs. The Commission preliminarily believes that it is now appropriate to mandate a structure whereby the regulatory staff of all exchanges and FINRA, as well as the Commission, can directly access comprehensive uniform cross-market order and execution information in real time pursuant to Commission rule, rather than through an information-sharing cooperative governed only by contract.

**E. Scalability of the EBS System and Rule 17a-25**

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<sup>154</sup> The different data fields and unique formats of each SRO audit trail present difficulties for Commission examinations and investigations, where time constraints can make it impractical to manually consolidate diverse data sets.

<sup>155</sup> See supra note 96.

Although the EBS system and Rule 17a-25 can be used to obtain information in conjunction with the SRO audit trail information, the Commission is concerned with the ability of the EBS system, as enhanced by Rule 17a-25, to keep pace with changes in the securities markets over recent years. Various changes in market dynamics have affected the utility of the EBS system and Rule 17a-25. For example, decimal trading has increased the number of price points for securities, and the volume of quotations and orders has correspondingly dramatically increased. Thus, the volume of transaction data subject to reporting under the EBS system can be significantly greater than the EBS system was intended to accommodate in a typical request for data. As a request-based system that is most useful when targeting trading in a specific security for a specific time, the EBS system is not well-suited as a broad-based tool to detect illegal or manipulative activity. The increased use of sponsored access (or other indirect access to an exchange) also has made it more difficult to use the EBS system and Rule 17a-25 to identify the ultimate customer that originates an order because the member broker-dealer through whom an order is sent to an exchange may not know the identity of the underlying customer.<sup>156</sup>

In addition, the increasing number of alternative trading venues creates more opportunities for orders to be routed to other markets and thus can result in delays in producing EBS data as requests must be made to several broker-dealers in the “chain” of an order. Finally, the increased trading of derivative instruments and products also has affected the ongoing effectiveness of the EBS system and Rule 17a-25. A market participant can use derivative

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<sup>156</sup> Indirect access is when a non-member of an exchange accesses an exchange through a member. For example, to comply with regulatory obligations such as Rule 611 of Regulation NMS (17 CFR 242.611), exchanges increasingly rely on indirect access to other exchanges through member broker-dealers of the other exchanges, so called “private linkage” access. Sponsored access is one type of indirect access and is governed by exchange rules. See, e.g., Nasdaq Rule 4611(d). The Commission recently proposed rules that would address sponsored access to exchanges. See Securities Exchange Act Release No. 61379 (January 26, 2010), 75 FR 4713 (January 29, 2010).

instruments and products as a substitute for trading in a particular equity, and likewise engage in illegal trading activity in derivative instruments and products. However, because information related to some derivative instruments over which the Commission has anti-fraud authority (such as security-based swaps) is not included within the EBS data or provided pursuant to Rule 17a-25, the EBS system and Rule 17a-25 are not effective tools for ascertaining activity in those markets or how that activity may be affecting the underlying equity market.<sup>157</sup>

In the Commission staff's experience, the EBS is most effective when investigating or analyzing trading in a small sample of securities over a limited period of time. But even under those circumstances, Commission staff often must make multiple requests to broker-dealers to obtain sufficient order information about the purchase or sale of a specific security to be able to adequately analyze the suspect trading. These multiple requests and responses can take a significant amount of time. The Commission preliminarily believes that the EBS system may no longer be able to fully support the regulatory challenges currently facing SRO and Commission regulatory staff.

The consolidated audit trail that the Commission is proposing today would provide significant improvements in the order and execution information available to SRO and Commission staff in several discrete ways. Among other things, the proposed audit trail would require that national securities exchanges and national securities associations and their members submit uniform order and execution information to a central repository on a real time basis, where possible. National securities exchanges and associations, and their member firms, would be required to identify the person with investment discretion for the order, and beneficial account

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<sup>157</sup> See infra Section III.A for a discussion of the scope of products to be covered by the proposed Rule and the intent to expand the scope to cover other products and transactions.



holder, if different, along with other key information about the customer or proprietary desk that placed or originated the order. The proposed consolidated audit trail also would cover any action taken with respect to the order through execution, or cancellation, as applicable, and thus would allow regulators to more easily trace the order from inception to cancellation or execution.<sup>158</sup>

The Commission preliminarily believes that the proposed audit trail information would greatly enhance the ability of SRO staff to effectively monitor and surveil the securities markets on a real time basis, and thus to detect and investigate illegal activity in a more timely fashion, whether on one market or across markets. The Commission also preliminarily believes that the proposal would improve the ability of Commission and SRO staff to conduct more timely and accurate trading analysis, as well as to conduct more timely and accurate market reconstructions, complex enforcement inquiries or investigations, and inspections and examinations of regulated entities and SROs.

### III. Description of Proposed Rule

To help address the deficiencies described above, the Commission is proposing to adopt a rule that would require national securities exchanges<sup>159</sup> and national securities associations<sup>160</sup> to

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<sup>158</sup> The proposed Rule also would require the reporting of certain post-trade information. See infra Section III.D.2.

<sup>159</sup> National securities exchange is defined in Rule 600(a)(45) of Regulation NMS as any exchange registered pursuant to Section 6 of the Exchange Act (15 U.S.C. 78f). 17 CFR 242.600(a)(45).

<sup>160</sup> National securities association is defined in Rule 600(a)(44) of Regulation NMS as any association of brokers and dealers registered pursuant to Section 15A of the Exchange Act (15 U.S.C. 78o-3). 17 CFR 242.600(a)(44). As noted above, see supra note 12, FINRA currently is the only national securities association to which the proposal would apply, as the NFA is restricted to regulating its members who are registered as broker-dealers in security futures products due to its limited purpose registration with the Commission under Section 15A(k) of the Exchange Act, 15 U.S.C. 78o-3(k). The NFA could, of course, seek to expand its current registration. Thus, for ease of reference, this proposal refers to FINRA but the proposed requirements would apply to any national securities association registered with the Commission.

create and implement a consolidated audit trail that captures customer and order event information, in real time, for all orders in NMS securities, across all markets, from the time of order inception through routing, cancellation, modification, or execution.

If adopted, the proposed Rule would require each national securities exchange and national securities association to file jointly with the Commission on or before 90 days from approval of this proposed Rule an NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail and a central repository.<sup>161</sup> The NMS plan would be required to be filed with the Commission pursuant to, and subject to the requirements of, Rule 608 of Regulation NMS.<sup>162</sup> As such, the proposed NMS plan would be published in the Federal Register and subject to public notice and comment in accordance with Rule 608(b). Further, the NMS plan filed pursuant to the proposed Rule, or any amendment to such a plan, would not become effective unless approved by the Commission or otherwise permitted in accordance with Rule 608.<sup>163</sup>

The Commission would expect the exchanges and FINRA to cooperate with each other and to take joint action as necessary to develop, file, and ultimately implement a single NMS plan to fulfill this requirement. The Commission requests comment on this approach. Specifically, the Commission requests comment on whether requiring the exchanges and associations to act jointly by filing an NMS plan that would contain the requirements for a consolidated audit trail is the most effective and efficient way to achieve the objectives of a

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<sup>161</sup> See infra Section III.F. for a discussion of the central repository. The proposed Rule would explicitly require each national securities exchange and national securities association to be a sponsor of the NMS plan submitted pursuant to the Rule and approved by the Commission. See proposed Rule 613(a)(4).

<sup>162</sup> 17 CFR 242.608. See proposed Rule 613(a)(2).

<sup>163</sup> See proposed Rule 613(a)(5) and 17 CFR 242.608.

consolidated audit trail. Or, should the Commission require the exchanges and associations to standardize or otherwise enhance their existing rules? What approach would be most efficient in improving the ability to monitor cross-market trading, or undertake market analysis or reconstructions, and why?

As discussed in further detail below, the proposed Rule would require that the NMS plan include provisions regarding: (1) the operation and administration of the NMS plan; (2) the creation and oversight of a central repository; (3) the data required to be provided by SROs and their members to the central repository; (4) clock synchronization; (5) compliance by national securities exchanges, FINRA, and their members with the proposed Rule and the NMS plan; and (6) the possible expansion of the NMS plan to products other than NMS securities.

The proposed Rule is designed to allow the national securities exchanges and national securities associations to develop the details of the NMS plan that they believe should govern the creation, implementation and maintenance of the central repository and consolidated audit trail, within the parameters set forth in the proposed Rule. The Commission believes that the national securities exchanges and national securities associations working jointly are in the best position to propose for themselves and their members the specifics of how the consolidated audit trail should be structured and administered. To this end, the proposed Rule contains a broad framework within which the exchanges and associations would provide the details that they believe would result in a functional, cooperative mechanism to create and maintain a consolidated audit trail, as well as certain explicit requirements the NMS plan must meet. As noted above, the proposed NMS plan developed by the exchanges and FINRA would be subject to public comment and approval by the Commission.

**A. Products and Transactions Covered**

Proposed Rule 613 would apply to secondary market transactions in all NMS securities, which means NMS stocks and listed options.<sup>164</sup> The Commission ultimately intends for the consolidated audit trail to cover secondary market transactions in other securities, including equity securities<sup>165</sup> that are not NMS securities, corporate bonds, municipal bonds, and asset-backed securities and other debt instruments;<sup>166</sup> credit default swaps, equity swaps, and other security-based swaps; and any other products that may come under the Commission's jurisdiction

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<sup>164</sup> NMS security is defined in Rule 600(a)(46) of Regulation NMS to mean any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options. 17 CFR 242.600(a)(46). NMS stock is defined in Rule 600(47) to mean any NMS security other than an option. 17 CFR 242.600(a)(46). A listed option is defined in Rule 600(a)(35) of Regulation NMS to mean any option traded on a registered national securities exchange or automated facility of a national securities association. 17 CFR 242.600(a)(35).

<sup>165</sup> Equity security is defined in Section 3(a)(11) of the Exchange Act to include any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security. See 15 U.S.C. 78c(a)(11).

Rule 3a11-1 under the Exchange Act defines equity security to include any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so. See 17 CFR 240.3a11-1.

<sup>166</sup> Asset-backed security means a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases. See 17 CFR 229.1101(c)(1).

in the future. Further, the Commission preliminarily believes that it would be beneficial to provide for the possible expansion of the consolidated audit trail to include information on primary market transactions in NMS stocks and other equity securities that are not NMS stocks, as well as primary market transactions in debt securities.<sup>167</sup> Such information could be used to monitor for violations of certain rules under the Exchange Act, such as Regulation M and Rule 10b-5 under the Exchange Act.<sup>168</sup> Further, FINRA's transaction reporting requirements for debt securities already cover primary market transactions in debt securities,<sup>169</sup> and thus FINRA members should already be recording information relating to such transactions that could be included in an audit trail. The Commission proposes that the scope of the Rule initially be limited to secondary market transactions in NMS securities, however, to allow for a manageable

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<sup>167</sup> A primary market transaction is any transaction other than a secondary market transaction and refers to any transaction where a person purchases securities in an offering. See, e.g., FINRA Rule 6710 (defining two types of primary market transactions for TRACE-eligible securities, a List or Fixed Offering Price Transaction or a Takedown Transaction).

<sup>168</sup> See 17 CFR 242.100 et. seq. and 17 CFR 240.10b-5. Rule 105 prohibits the short selling of equity securities that are the subject of a public offering for cash and the subsequent purchase of the offered securities from an underwriter or broker or dealer participating in the offering if the short sale was effected during a period that is the shorter of the following: (i) beginning five business days before the pricing of the offered securities and ending with such pricing; or (ii) beginning with the initial filing of such registration statement or notification on Form 1-A or Form 1-E and ending with the pricing. Thus, Rule 105 prohibits any person from selling short an equity security immediately prior to an offering and purchasing the security by participating in the offering. The primary market transaction data would allow for the ability to more quickly identify whether any participant in the offering sold short prior to the offering.

Rule 10b-5 prohibits any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security. The primary market transaction data for bonds would allow for identification of the cost basis for bond purchases by intermediaries and make it easier to assess whether subsequent mark-ups to retail investors in primary offerings are fair and reasonable and, if not, whether there has been a violation of the antifraud provisions of the federal securities laws.

<sup>169</sup> See FINRA Rule 6730(a)(5).

implementation of the proposed consolidated audit trail, and because market participants already have experience with audit trails for these types of transactions in these securities.

As discussed above, the Commission believes that implementing a consolidated audit trail for NMS securities would aid the SROs in more effectively and efficiently carrying out their regulatory responsibilities. It would also assist the Commission in carrying out its statutory responsibilities. The Commission further preliminarily believes that a timely expansion of the scope of the consolidated audit trail beyond NMS securities would be beneficial, as illegal trading strategies that the consolidated audit trail would be designed to help detect and deter, such as insider trading, may involve trading in multiple related products other than NMS securities across multiple markets.

For example, the Commission routinely receives information relating to possible upward manipulation of security prices in violation of Sections 9(a) and 10(b) of the Exchange Act,<sup>170</sup> and alleged abusive short selling in the over-the-counter market, which includes FINRA's Bulletin Board and Pink Sheets. If the consolidated audit trail were expanded to cover these securities, it would be possible for SROs and the Commission to make comparisons between current and historical data in a more timely manner than is currently possible, to more quickly determine whether or not a complaint merits additional attention and the corresponding commitment of enforcement resources. Similarly, to the extent that instruments currently not considered NMS securities can be substitutes for long or short positions in NMS securities, having access to an audit trail that documents trading activity in such securities would improve the Commission's ability to make a risk assessment as to information it has received about

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<sup>170</sup> 15 U.S.C. 78i(a) and 78j(b).

possibly manipulative activity.<sup>171</sup> Having ready access to this information in an audit trail also would improve the Commission's inspection process because it would enhance risk assessment and allow for better selection as to which broker-dealers to examine. For example, the information would allow for better trend analysis and outlier identification. It also would improve pre-examination work and the asset verification process,<sup>172</sup> and focus document requests, making the examination process more efficient for the Commission staff and the registrants subject to the process.

To help ensure that such an expansion would occur in a reasonable time and that the systems and technology that would be used to implement the Rule as proposed are designed to be easily scalable, proposed Rule 613(i) would require that the NMS plan contain a provision requiring each national securities exchange and national securities association that is a sponsor of the plan<sup>173</sup> to jointly provide the Commission a document outlining how the sponsors could incorporate into the consolidated audit trail information with respect to: (1) equity securities that are not NMS securities; (2) debt securities, including asset-backed securities; and (3) primary market transactions in NMS stocks, equity securities that are not NMS securities, and debt

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<sup>171</sup> The Commission's Division of Enforcement has recently established an Office of Market Intelligence. This Office, among other things, conducts intake and triage of investor and industry referrals that are received by the Commission each year. Currently, a thorough review of referrals requires extensive resource allocation as the primary source for evaluating trading data is the EBS system. Expansion of the consolidated audit trail to non-NMS securities would allow that Office to evaluate the merits of each referral faster and more effectively, and more efficiently allocate enforcement resources to appropriate cases.

<sup>172</sup> Asset verification is an exam process that attempts to locate independent information to verify certain customer positions, transactions, and balances at broker-dealers.

<sup>173</sup> Sponsor, when used with respect to an NMS plan, is defined in Rule 600(a)(70) of Regulation NMS to mean any self-regulatory organization which is a signatory to such plan and has agreed to act in accordance with the terms of the plan. See 17 CFR 242.600(a)(70).

securities. The sponsors specifically would be required to address, among other things, details for each order and reportable event that they would recommend requiring to be provided; which market participants would be required to provide the data; an implementation timeline; and a cost estimate.

The Commission requests comment on the proposed scope of products to be covered by the consolidated audit trail. Should the consolidated audit trail initially cover securities other than NMS securities? Why or why not? The Commission also requests comment on whether the approach to expand the consolidated audit trail to include the products and transactions specified above represents an appropriate expansion of the consolidated audit trail, and what additional capital commitment would be required by the various market participants to implement such an expansion. Please be specific in your response with respect to different products or transactions (e.g. security-based swaps, or primary market transactions in NMS stocks). Are there other securities or products that should be identified and included in a future expansion? What would be the challenges to any expansion to the products and transactions listed above? Are there any other actions that the Commission or SROs would need to take to be able to expand the audit trail to certain products or transactions? Should the Commission consider expansion to certain products or transactions before others? The Commission also requests comment on an appropriate and realistic time frame for including these other products and transactions in the consolidated audit trail and whether an expansion should be done in phases.

The Commission also requests comment on whether implementation of the proposed Rule, which would apply to NMS securities, would have an impact on trading activity by market participants in products not initially covered by the proposed Rule. The proposed consolidated audit trail is designed to provide the SROs and the Commission a tool to more effectively, and in



a more timely manner, identify potential manipulative or other illegal activity. More timely detection and investigation of such activity may lead to greater deterrence of future illegal activity if potential wrongdoers perceive a greater chance of regulators identifying their activity in a more timely fashion. Do commenters believe that the existence of the proposed audit trail would alter market participants' trading behavior, such as by shifting their trading to products or markets not covered by the proposed Rule to avoid detection of illegal activity using consolidated audit trail data? Would the proposal impact a market participant's analysis of the potential risks and benefits of manipulative activity involving NMS securities? If so, how so? In addition, to the extent commenters believe that market participants may alter their trading behavior, such as by shifting trading to products that are not initially covered by the proposed Rule to avoid detection of manipulative activity, the Commission requests comment on the importance of expanding the consolidated audit trail to cover additional products.

#### **B. Orders and Quotations**

The proposed Rule would require that information be provided to the central repository for every order in an NMS security originated or received by a member of an exchange or FINRA. The proposed Rule would define "order" to mean: (1) any order received by a member of a national securities exchange or national securities association from any person; (2) any order originated by a member of a national securities exchange or national securities association; or (3) any bid or offer.<sup>174</sup> Thus, the proposed consolidated audit trail would cover all orders (whether for a customer or for a member's own account) as well as quotations in NMS stocks and listed

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<sup>174</sup> See proposed Rule 613(j)(4). Bid or offer is defined in Rule 600(a)(8) of Regulation NMS to mean the bid price or the offer price communicated by a member of a national securities exchange or member of a national securities association to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of an NMS security, as either principal or agent, but shall not include indications of interest. 17 CFR 242.600(a)(8).

options.<sup>175</sup> Each member would be required to report to the central repository the origination of its own orders or quotations, and the SRO to which the member sends its orders and quotations would be required to report receipt and execution, if applicable, of those orders and quotations. Because the origination of the quotations would already be reported to the central repository by the member, an SRO would not be required to separately submit to the central repository its best bids and offers that it is required to submit to the central processors.<sup>176</sup>

The Commission preliminarily believes that the inclusion of orders for a member's own account ("proprietary orders") and their bids and offers in the scope of the consolidated audit trail is necessary and appropriate to effectively and efficiently carry out the stated objectives of the consolidated audit trail. The SROs would not be able to use the consolidated audit trail data to surveil trading by broker-dealers through their proprietary accounts if that information is not included in the audit trail. Further, including proprietary orders and quotations in the consolidated audit trail would permit SROs to harness the intended benefits of the consolidated audit trail to more efficiently monitor for violations of SRO rules where the exact sequence of the receipt and execution of customers orders in relation to the creation and execution of proprietary orders or quotations is important to determine whether or not a violation occurred. For example, SROs would be able to use the consolidated audit trail data to more efficiently monitor for instances where a broker-dealer receives a customer order, then sends a proprietary order to one exchange or updates its quotations on an exchange prior to sending the customer order to another exchange, in possible violation of the trading ahead prohibitions in their rules.<sup>177</sup>

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<sup>175</sup> Quotation is defined in Rule 600(a)(62) of Regulation NMS to mean a bid or an offer. 17 CFR 242.600(a)(62).

<sup>176</sup> See Rule 601 of Regulation NMS, 17 CFR 242.601.

<sup>177</sup> See, e.g., FINRA Rule 5320 and NYSE Arca Equities Rule 6.16.

Another example where information on proprietary orders or quotations would be useful to have included in the consolidated audit trail is in the investigation of a possible "spoofing" allegation. In those cases, a market participant enters and may immediately cancel limit orders or quotations in a specific security with the intent of having those non-bona fide orders or quotations change the national best bid and national best offer ("NBBO"). Because a market participant could conduct this activity across multiple markets, using different accounts, the lack of consolidated data makes it much more difficult to identify the source of the orders or quotations and thus to determine whether the quoted price was manipulated or simply responding to market forces. The Commission therefore preliminarily believes that having information on proprietary orders and quotations in the consolidated audit trail along with customer order information would greatly enhance the ability of the SROs to detect potentially violative activity.

The Commission requests comment on its proposed definition of "order" and the scope of the proposed consolidated audit trail. Specifically, the definition would include orders received and originated by SRO members, as well as quotations originated by SRO members. Should it include quotations? Why or why not? Are there any differences between orders and quotations that should be taken into account with respect to the information that would be required to be provided to the central repository with respect to each bid or offer, or with respect to how, or which entity, should be required to report quotation information to the central repository? For example, the Commission understands that out-of-the-money options generate a high volume of automated quotation updates to reflect changes in the price of the underlying security, yet these series often have very little trading activity. Should this type of quotation be required to be submitted to the central repository? If not, is there any way to distinguish these quotations from other quotations that commenters believe should be reported, such as quotations generated by a

profit-seeking algorithm? What is the magnitude of quotation data compared to order data and trade data, for both NMS stocks and listed options? Please provide any empirical data. Would there be a significant cost savings to the submission and collection of certain quotation information (for example, quotations in listed options) by end-of-day instead of in real time? If so, please quantify.

The Commission also requests comment with respect to including proprietary orders as well as customer orders in the scope of the consolidated audit trail. Specifically, are there any differences between customer orders and proprietary orders that should be taken into account with respect to the information that would be required to be provided to the central repository with respect to proprietary orders? The Commission also requests comment on how, if at all, the consolidated audit trail should take into account instances where an SRO's quotations (which can include orders received from members as well as quotations) are not actionable, such as when an exchange has a systems failure. Should non-firm quotations be marked in the consolidated audit trail to show they are not firm? If so, how would that be accomplished where it is the exchange making the determination its quotations are not firm, not the member that submitted the order or quotation?

**C. Persons Required to Provide Information to the Central Repository**

Proposed Rule 613 would require, through the mechanism of an NMS plan and exchange and association rules adopted pursuant to an NMS plan, national securities exchanges, national securities associations, and their respective members<sup>178</sup> to provide certain information regarding

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<sup>178</sup> A member of a national securities exchange is defined in Section 3(a)(3)(A) of the Exchange Act to mean: (1) any natural person permitted to effect transactions on the floor of the exchange without the services of another person acting as broker; (2) any registered broker or dealer with which such a natural person is associated; (3) any registered broker or dealer permitted to designate as a representative such a natural

each order and each reportable event<sup>179</sup> to the central repository.<sup>180</sup> The Commission notes that requiring all members to provide certain information would capture alternative trading systems (“ATs”).<sup>181</sup>

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person; and (4) any other registered broker or dealer which agrees to be regulated by such exchange and with respect to which the exchange undertakes to enforce compliance with the provisions of the Exchange Act, the rules and regulations thereunder, and its own rules. Further, for purposes of Sections 6(b)(1), 6(b)(4), 6(b)(6), 6(b)(7), 6(d), 17(d), 19(d), 19(e), 19(g), 19(h), and 21 of the Exchange Act, the term “member” when used with respect to a national securities exchange also means, to the extent of the rules of the exchange specified by the Commission, any person required by the Commission to comply with such rules pursuant to Section 6(f) of this title. See 15 U.S.C. 78c(a)(3)(A).

A member of a registered securities association is defined in Section 3(a)(3)(B) of the Exchange Act to mean any broker or dealer who agrees to be regulated by such association and with respect to whom the association undertakes to enforce compliance with the provisions of the Exchange Act, the rules and regulations thereunder, and its own rules. See Section 3(a)(3)(B) of the Exchange Act, 15 U.S.C. 78c(a)(3)(B). Section 15(b)(8) of the Exchange Act, 15 U.S.C. 78o(b)(8), states that it shall be unlawful for any registered broker or dealer to effect any transaction in, or induce or attempt to induce the purchase or sale of, any security (other than commercial paper, bankers’ acceptances, or commercial bills), unless such broker or dealer is a member of a securities association registered pursuant to Section 15A of the Exchange Act or effects transactions in securities solely on a national securities exchange of which it is a member.

Rule 15b9-1(a) under the Exchange Act, 17 CFR 240.15b9-1(a), generally states that any broker or dealer required by Section 15(b)(8) of the Exchange Act to become a member of a registered national securities association shall be exempt from such requirement if it is a member of a national securities exchange; carries no customer accounts; and has annual gross income derived from purchases and sales of securities otherwise than on a national securities exchange of which it is a member in an amount no greater than \$1,000.

<sup>179</sup> Reportable event would be defined in proposed Rule 613(j)(5) to include, but not be limited to, the receipt, origination, modification, cancellation, routing, and execution (in whole or in part) of an order.

<sup>180</sup> See infra Section III.D. for a detailed discussion of the information that would be required to be provided to the central repository, and infra Section III.H.2. for a discussion of the requirement that the exchanges and FINRA adopt rules to implement the requirements of the NMS plan for their members.

<sup>181</sup> An ATs is defined in Rule 300(a) of Regulation ATs. See 17 CFR 242.300(a). Regulation ATs requires ATs to be registered as broker-dealers with the Commission, which entails becoming a member of FINRA and fully complying with the broker-dealer regulatory regime. See Concept Release on Equity Market Structure, supra note 19, at 3599.

The Commission's intent is to require any entity acting in a broker or dealer capacity that would receive an order from a customer or originate an order for its own account to provide information to the central repository. The Commission requests comment on whether requiring all members of each exchange and association to provide the required information would encompass all broker or dealers or other persons that would receive or originate orders, as defined in the proposed Rule. If not, why not? The Commission requests comment on whether it should, in the alternative, require all brokers and dealers registered with the Commission to provide such information, rather than all members of an exchange or association. Would applying the requirements to registered brokers and dealers encompass all persons that would be able to receive or originate orders as defined in the proposed rule? Are there persons that are not registered as a broker or dealer, and that are not a member of an exchange or association, that would still receive or originate orders in NMS securities? How should the Commission address that situation to promote inclusion of all relevant orders and executions in a consolidated audit trail?

**D. Provision of Information to the Central Repository**

Proposed Rule 613(c)(1) generally would require the NMS plan to provide for an accurate, time-sequenced record of orders beginning with the receipt or origination of an order by a member of a national securities exchange or national securities association, and further documenting the life of the order through the process of routing, modification, cancellation, and execution (in whole or in part). To effectuate this goal, proposed Rule 613(c)(2) would require the NMS plan to require each national securities exchange, national securities association, and

member of such exchange or association to collect and provide to the central repository certain information with respect to orders in NMS securities.<sup>182</sup>

Specifically, the proposed Rule would require the NMS plan to require each national securities exchange and its members to collect and provide to the central repository certain order information for each NMS security registered or listed for trading on such exchange or admitted to unlisted trading privileges on such exchange.<sup>183</sup> The proposed Rule also would require the NMS plan to require each national securities association and its members to collect and provide to the central repository certain order information for each NMS security for which transaction reports are required to be submitted to the association.<sup>184</sup> The Commission requests comment on whether requiring exchanges and their members, and associations and their members, to report information for orders for these securities to a central repository is appropriate, and whether the requirements, as proposed, would cover all NMS securities.<sup>185</sup>

As discussed below in Section III.D.1., certain of the information would be required to be captured and transmitted to the central repository on a real time basis, meaning immediately and with no built in delay from when the reportable event occurs.<sup>186</sup> Other information would be permitted to be captured and transmitted to the central repository promptly after the exchange, association, or member receives the information, but in no instance later than midnight of the day that the reportable event occurs or the exchange, association, or member receives such

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<sup>182</sup> See Sections III.D.1. and III.D.2. below for a detailed discussion of the information that would be required to be provided to the central repository.

<sup>183</sup> See proposed Rule 613(c)(5).

<sup>184</sup> See proposed Rule 613(c)(6).

<sup>185</sup> See *infra* Section III.F. for a discussion of the central repository.

<sup>186</sup> See proposed Rule 613(c)(3). See *supra* note 179 for a definition of reportable event.

information.<sup>187</sup> The data collected by the national securities exchanges, national securities associations, and their members would be required to be electronically transmitted to the central repository in a uniform electronic format.<sup>188</sup>

**1. Information to be Provided to the Central Repository in Real Time**

As discussed above in Section II.A.4., the Commission preliminarily believes that requiring the submission of consolidated audit trail information on a real-time basis would help enable more timely cross-market monitoring or surveillance and investigations of, or other responses to, market anomalies. Regulators therefore could more easily and quickly identify manipulative or other undesirable activity. Having the information available in real time would allow the staff of the SROs to run certain cross-market surveillances in real time to ascertain whether anomalous trading activity is occurring, and the SROs could then more quickly begin an investigation into the suspected anomalous trading. Timely pursuit of potential violations can be important in seeking to freeze any profits received from illegal activity before they are spent or otherwise become unreachable (for instance, by being transferred out of the country). The Commission also preliminarily believes that requiring the submission of audit trail information in real time would enable the Commission to access the information on a more timely basis than currently is the case, to support its examination and enforcement activities, as well as its analysis of market activity.<sup>189</sup>

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<sup>187</sup> See proposed Rule 613(c)(4). This requirement to report no later than midnight on the day that the reportable event occurs or the exchange, association or member receives the information would be determined using the local time of the entity reporting the information to the central repository.

<sup>188</sup> See proposed Rule 613(c)(2).

<sup>189</sup> See *supra* notes 28, 154, and 171 and accompanying text.



The Commission requests comment as to whether it is feasible to require the submission of the proposed audit trail information, as detailed below, to the central repository on a real time basis. If the information is not submitted on a real time basis, when should the information be submitted to the central repository? Would real time order and execution information be useful for cross-market surveillance and investigations of market anomalies? If so, how? If not, why not? Please discuss the costs and benefits of recording and transmitting the data in real time, or not in real time. For example, how would costs differ between submitting end-of-day data compared to real time data? Are there categories of information that would be easier to produce on a real time basis than others? What types of systems modifications by the exchanges, FINRA, and their respective members would be necessary to collect and submit the required audit trail information to the central repository on a real time basis? Please respond with specificity. The Commission further requests comment on whether the requirement to report information in real time should be limited to a specific time period during the day, such as when the markets for trading NMS stocks and listed options are open for trading? Or some other time period? How much lower would the cost be to submit data in real time during trading hours than during the whole day? Or some other time period? Are there practical issues with requiring real time reporting throughout the day? Would requiring data to be submitted in real time all day, as proposed, allow the ability to perform systems maintenance if necessary? If commenters support the requirement to report information in real time, do they believe that there are times during the day when real time reporting may be unnecessary? Why or why not?

Proposed Rule 613(c)(3) would require the NMS plan to require each exchange, association, and member to collect and provide to the central repository on a real time basis

details for each order and each reportable event,<sup>190</sup> as outlined below. Each exchange, association, or member would be required to report the information for each order, for each reportable event, only with respect to an action taken by the exchange, association, or member. For example, if a member receives an order from a customer, the member would be required to report the receipt of that order (with the required information) to the central repository. If the member then routed that order to an exchange for execution, the member would be required to report the routing of that order (with the required information) to the central repository. Likewise, the exchange would be required to report the receipt of that order from the member (with the required information) to the central repository. If the exchange executed the order on its trading system(s), the exchange would be required to report that execution of the order (with the required information) to the central repository, but the member would not also be required to report the execution of the order to the central repository. If the member executed the order in the over-the-counter market, however, rather than routing the order to an exchange (or other market center) for execution, the member would be required to report the execution of the order to the central repository.

**i. Customer Information**

The proposed Rule specifically would require, for the receipt or origination of each order, information to be reported to the central repository with respect to the customer that generates the order -- specifically, the beneficial owner(s) of the account originating the order and the person exercising investment discretion for the account originating the order, if different from the beneficial owner.<sup>191</sup> As discussed above in Section II.A.1, such information generally is

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<sup>190</sup> See supra note 179 for a definition of reportable event.

<sup>191</sup> The proposed Rule would define "customer" to mean the beneficial owner(s) of the account originating the order and the person exercising investment discretion for the

neither required nor captured on existing audit trails. While Rule 17a-25 requires broker-dealers to electronically submit information about customer and proprietary securities trading, such information is required to be submitted to the Commission only upon request. The Commission preliminarily believes that the usefulness of audit trail information for purposes of effective enforcement and cross-market surveillance of trading activity would be greatly improved by having the identity of the customer electronically attached to the report of the receipt or origination of each order that is sent to the central repository.<sup>192</sup>

The proposed Rule would require that the NMS plan require, for the receipt or origination of an order, the provision to the central repository of information of sufficient detail to identify the customer.<sup>193</sup> The Commission preliminarily believes that the customer name and address would be sufficient detail to identify the customer. In addition, the proposed Rule would require the provision of customer account information, which would be defined in proposed Rule 613(j)(2) to include but not be limited to: (1) the account number; (2) account type (e.g. options); (3) customer type (e.g., retail, mutual fund, broker-dealer proprietary); (4) the date the account was opened; and (5) the large trader identifier (if applicable).<sup>194</sup> The Commission preliminarily believes that information on the type of account and when it was opened would be important to investigations of potential insider trading. For example, knowing when in time the

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account originating the order, if different from the beneficial owner(s). See proposed Rule 613(j)(1). The Commission notes that this proposed definition of customer is only for purposes of proposed Rule 613, and what information would be required to be collected and disclosed by members to the central repository. The Commission does not intend to alter the responsibilities that broker-dealers are already subject to pursuant to SRO rules, or the federal securities laws, rules or regulations or other laws, with respect to the customers (for example, suitability rules, see, e.g. NASD Rule 2310).

<sup>192</sup> See supra Section II.A.

<sup>193</sup> See proposed Rule 613(c)(7)(i)(A).

<sup>194</sup> See proposed Rule 613(c)(7)(i)(C). See also Large Trader Proposal, supra note 11.

customer opened the account in relation to the suspicious trading activity, or whether the customer changed account authorization to permit options trading just before suspicious options trading, could be evidence of intent. The Commission notes that currently any member receiving orders from a customer would be required, as part of its compliance with its books and records requirements,<sup>195</sup> to take reasonable and appropriate steps to ensure the accuracy of the customer information received. This should not change, if this proposal were adopted, with respect to customer information recorded and provided to the central repository.

The proposed Rule also would require a unique customer identifier for each customer.<sup>196</sup> The unique customer identifier should remain constant for each customer, and have the same format, across all broker-dealers. This unique customer identifier would serve a similar purpose to a customer's social security number or tax identification number, obviating the need to include that information in the consolidated audit trail data. The Commission is not proposing to mandate the method for achieving this requirement, so as to allow those entities subject to the proposed Rule flexibility to determine the most practical way to accomplish the requirement of having unique customer identifiers. However, one alternative could be to have the central repository be responsible for assigning a unique customer identifier in response to an input by a member of a customer's social security number or tax identification number. If the customer already has been assigned a unique identifier because of a prior request by another member, the central repository would provide to the member that same identifier. If no unique identifier has previously been assigned, the central repository could assign a new one. Access to this part of the central repository's functionality could be more tightly controlled than access to the

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<sup>195</sup> See, e.g., Rules 17a-3, 17a-4, and 17a-25 under the Exchange Act, 17 CFR 240.17a-3, 17a-4, and 17a-25.

<sup>196</sup> See proposed Rule 613(c)(7)(i)(B).

consolidated audit trail data, to help ensure the confidentiality of the social security or tax identification numbers.

The Commission requests comment as to whether each item of information regarding the customer is necessary for an effective consolidated audit trail. Is there any additional data that should be included to help identify the customer submitting the order? The Commission also requests comment on the proposed definition of customer. For example, should the definition only include the person exercising investment discretion? Should the definition include the beneficial owner? Should the customer information requirement also include a unique identifier for the particular computer algorithm used by the firm to generate the order, if applicable? Is there a better way to identify in the audit trail individual algorithmically-generated trading strategies? Should each trading desk at a member be required to have its own unique customer identifier, to the extent the trading desk is originating orders for the account of the member? This information on specific algorithms or trading desks could be useful to focus an inspection or investigation, if regulators could tell from the audit trail data that there was a pattern of suspicious trading activity from a specific algorithm or desk.

The Commission requests comment as to what systems modifications, if any, would be required for members to collect and to provide this customer identification information to the central repository. Do broker-dealers currently keep this information electronically? If not, what changes would need to be made to collect and provide this information for existing accounts to the central repository? What would be the cost of converting this information into an electronic, accessible and linked format? Please be specific in your response. Further, the Commission requests comment on whether there are laws or other regulations in non-U.S. jurisdictions that would limit or prohibit a member from obtaining the proposed customer information for non-

U.S. customers. If so, what are they? How do members currently obtain such information for such customers? If there are special difficulties in obtaining customer information from non-US jurisdictions, how should the consolidated audit trail be modified or otherwise reflect that difficulty?

The Commission requests comment on other possible ways to develop and implement unique customer identifiers. For example, who should be responsible for generating the identifier? The Commission also requests comment on whether a unique customer identifier, together with the other information with respect to the customer that would be required to be provided under the proposed Rule, is sufficient to identify individual customers. Are there any concerns about how the customer information will be protected? If so, what steps should be taken to ensure appropriate safeguards with respect to the submission of customer information, as well as the receipt, consolidation, and maintenance of such information in the central repository.

In addition, the Commission requests comment on whether the requirement to provide customer information to the central repository in real time would impact market participants' trading activity? If so, how so? For example, would market participants be hesitant to engage in certain legal trading activity because of a concern about providing customer information in real time? Would market participants shift their trading activity to products or markets that do not require the capture of customer information to avoid compliance with this requirement of the proposed Rule? If so, how should the Commission address those concerns? On the other hand, would enhanced surveillance of the markets as a result of the consolidated audit trail attract additional trading volume to the U.S. markets?

**ii. National Securities Exchange, National Securities Association and Broker-Dealer Identifier Information**

Each member originating or receiving an order from a customer, and each national securities exchange, national securities association, and member that subsequently handles the order, would be required to include its own unique identifier in each report it sends to the central repository for a reportable event. Such an identifier would allow the Commission and SRO staff to determine which member facilitated the transaction and assist in assessing compliance with various SRO or Commission rules, such as the limit order display rule (Rule 604 of Regulation NMS).<sup>197</sup> This is especially important for ensuring that individual customer orders are handled and executed in accordance with SRO and Commission rules. In addition, routing decisions are an important aspect in assessing order execution quality and compliance with a member's duty of best execution. Further, if applicable, the member receiving an order from a customer would be required to report an identifier specifying the branch office and the registered representative at the member receiving the order. These identifiers would be unique to the exchange, association, member, branch office, and registered representative.

The proposed Rule would not require that these unique identifiers "travel" with an order throughout its life, but would require that the unique identifier of each member or SRO that is taking an action with respect to the order be attached to the report of each reportable event that the member, exchange or association is reporting to the central repository. Each report in the life of the order would be able to be linked together at the central repository through the unique order identifier. Therefore, the Commission preliminarily does not believe that the unique identifier of each member or market that touches an order needs to travel with the order for the life of the order as long as the unique identifier of the member or exchange taking the action is included. For example, if Member A receives an order from a customer, Member A would be required to

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<sup>197</sup> 17 CFR 242.604.

report the receipt of that order to the central repository and include Member A's unique identifier. If Member A then routed that order to another member, Member B, Member A would be required to report the routing of that order to the central repository and include Member A's unique identifier as well as the unique identifier of Member B. Likewise, Member B would be required to report the receipt of that order from Member A to the central repository and include the unique identifiers of Member A and Member B. If Member B then routed the order to Exchange A for execution, Member B would be required to report the routing of the order to the central repository and include the unique identifier of Member B and Exchange A, but not Member A.

The Commission requests comment as to who should be responsible for generating unique identifiers for national securities exchanges, national securities associations, and their members. Would it be feasible for each national securities exchange, national securities association, or member to develop its own identifier for this purpose? The Commission also requests comment on the level of specificity for each unique member identifier – should it be designed to identify the firm, trading desk or individual registered representative? What are the advantages or disadvantages of requiring a unique identifier that would allow identification of an individual registered representative as opposed to just the member entity? The Commission also requests comment on procedures or safeguards market participants believe are necessary or appropriate so that these unique identifiers are routed accurately.

### **iii. Receipt or Origination of an Order**

The proposed Rule would require the NMS plan to require members of each of the exchanges and FINRA to collect and provide to the central repository certain key items of information about an order as soon as the member receives or originates an order, including the



customer information as described above. The proposed Rule would require the member to report the date and time (to the millisecond) that an order was originated or received.<sup>198</sup> The member also would be required to report the material terms of the order.<sup>199</sup> Material terms of the order would be defined to include, but not be limited to, the following information: (1) the NMS security symbol; (2) the type of security; (3) price(s) (if applicable); (4) size (displayed and non-displayed); (5) side (buy/sell); (6) order type; (7) if a sell order, whether the order is long, short, or short exempt;<sup>200</sup> (8) if a short sale, the locate identifier; (9) open/close indicator; (10) time in force (if applicable); (11) whether the order is solicited or unsolicited; (12) whether the account has a prior position in the security; (13) if the order is for a listed option, option type (put/call), option symbol or root symbol, underlying symbol, strike price, expiration date, and open/close; and (14) any special handling instructions.<sup>201</sup>

The information described would assist the SROs, and the Commission as well, in determining the exact time of order receipt or origination, as well as provide a record of all of the original material terms of an order. The entry time of orders can be critical information in enforcement cases. In insider trading investigations, for example, the entry time of the order may be a critical piece of evidence in determining whether or not an individual acted with the

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<sup>198</sup> See proposed Rule 613(c)(7)(i)(H). Requiring time to the millisecond is consistent with current industry standards. The SIPs currently support millisecond time stamps. See, e.g., SIAC's CQS Output Specifications Revision 40 (January 11, 2010); SIAC's CTS Output Specifications Revision 55 (January 11, 2010); and Nasdaq's UTP Plan Quotation Data Feed Interface Specifications Version 12.0a (November 9, 2009).

<sup>199</sup> See proposed Rule 613(c)(7)(i)(I).

<sup>200</sup> A broker or dealer must mark all sell orders of any equity security as long, short, or short exempt. See Rule 200(g)(1) under the Exchange Act, 17 CFR 242.200(g)(1). A sell order may be marked short exempt only if the conditions of Rule 201(c) or (d) under the Exchange Act are met (17 CFR 242.201(c) and (d)). See Rule 200(g)(2), 17 CFR 242.200(g)(2).

<sup>201</sup> See proposed Rule 613(j)(3).

requisite scienter to violate the federal securities laws. Similarly, in investigating possible market abuse violations, such as trading ahead of a customer order, the relationship between order origination, the terms of the order, and order entry of various other orders on multiple venues, may be at issue. As noted above, requiring that the time of a reportable event be reported in milliseconds is consistent with current industry standards. The Commission requests comment on whether this is an appropriate time standard. Do commenters believe that the time standard should be shorter? If so, what should be the standard, and why? Would requiring a shorter time standard for reporting actually provide more precision in the timing of events? How would your answer be impacted by the extent to which market participants' clocks are synchronized? Alternatively, do commenters believe that it would be more appropriate to require in the proposed Rule that the time of reporting be consistent with industry standards, rather than including a specific time standard (recognizing that the SROs could choose to include a specific time standard in the NMS plan)?

An open/close indicator currently is required to be submitted to exchanges for listed option orders<sup>202</sup> and indicates whether the trade is opening a new position or increasing an existing position rather than closing or decreasing an existing position. The open/close indicator provides information to more easily track the size and holding time for individual positions, and thus to more easily track open interest and short interest. In addition, an open/close indicator could be used to indicate when a buy order in a stock is a buy to cover on a short sale. This information is useful in investigating short selling abuses and short squeezes. For example, a build up of a large short position by one investor along with the spreading of rumors may be indicative of using short selling as a tool to potentially manipulate prices. Information on when

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<sup>202</sup> See, e.g., CBOE Rule 6.51; BATS Rule 20.7; and ISE Rule 1404.

the position decreases is also useful for indicating potential manipulation, insider trading, or other rule violations. Information on whether the account has a prior position in the security is useful in a number of investigations. For example, the ability to easily determine whether an order adds to a position, along with the timing of the order, is particularly important in detecting and investigating portfolio pumping or marking the close. Also, information on whether the account has a prior position may be important in investigating "layering" or "spoofing."

Layering and spoofing are manipulations where orders are placed close to the best buy or sell price with no intention to trade in an effort to falsely overstate the liquidity in a security.

The Commission intends that the items of information required to be reported to the central repository for the receipt or origination of an order, at a minimum, include substantially all of the information currently required to be reported, or provided upon request, under the exchanges' and FINRA's existing order audit trail rules, as well as the EBS system rules and Rule 17a-25 under the Exchange Act. The Commission requests comment as to whether there are any items of information that are required to be recorded and reported by existing audit trail rules, or to be provided to the SROs or Commission upon request, that are not included within the proposed Rule that commenters believe should be included. If there are, please identify each item of information and discuss why you believe that such information should be included in the proposed consolidated audit trail. The Commission also requests comment on whether there are items of information included in the current SRO audit trails, and which are proposed to be included in the consolidated audit trail, that are unnecessary for surveillance, investigative or other regulatory purposes. If so, what are these data elements and why are they not necessary as part of a consolidated audit trail? Are they relevant for other purposes? The Commission further requests comment on whether it should require, as part of the disclosure of special handling

instructions, the disclosure of an individual algorithm that may be used by a member or customer to originate or execute an order, and if so, how such an algorithm should be identified.

As noted above, members currently are required to indicate whether an order would open or close a position for listed options.<sup>203</sup> The Commission requests comment as to what extent members currently obtain or have access to this information from their customers, or track this information for their own proprietary orders, for all NMS securities. If members currently do obtain this information, is the information collected and stored electronically? If members currently do not have access to or obtain this information for customer orders, what would be the impact of the proposed requirement to collect and provide this information to the central repository? What would be the costs, if any, of collecting and providing this information? Please explain and quantify any potential impact or costs.

The proposed Rule does not specify exact order types (e.g., market, limit, stop, pegged, stop limit) to be included as material terms of an order because order types may differ across markets, and even an order type with the same title may have a different meaning from one exchange to another. Further, markets are frequently creating new order types and eliminating existing order types. In addition, the Commission notes that it may be difficult to distinguish between an "order type" and a special-handling instruction, such as "do not display." The Commission therefore preliminarily believes that it would not be practical to include in the proposed Rule a list of order types in the required information to be reported to the central repository. The Commission notes, however, that the SROs may choose to include more detail in the NMS plan. The Commission requests comment on this approach. The Commission also requests comment as to whether there are other items of information that would be required to be

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<sup>203</sup>

Id.

reported to the central repository that have, or may have, different meanings across different exchanges. If so, what are they? How should these differences be addressed in the proposed Rule?

The proposed Rule also would require the NMS plan to require each member of an exchange or FINRA to “tag” each order received or originated by the member with a unique order identifier that would be reported to the central repository and that would stay with that order throughout its life, including routing, modification, execution, and cancellation.<sup>204</sup> The members, exchanges, and FINRA would be required to pass along the unique order identifier with the order when routing the order, and the unique order identifier would be required on each reportable event report. For example, Member ABC that receives an order from a customer would immediately assign it a unique order identifier, and would report that identifier to the central repository along with the rest of the required information. If Member ABC subsequently routed the order to another member, Member DEF, Member ABC would be required to pass along to Member DEF the unique order identifier, as well as to attach the unique order identifier when reporting the routing of the order to the central repository. If Member DEF routed the order to Exchange A for execution, Member DEF would pass along to Exchange A with the order the unique order identifier, and would attach the identifier on the report of the route sent to the central repository. Exchange A would be required to attach the unique order identifier when reporting receipt of the order, and an execution of the order (if applicable) to the central repository.

The Commission recognizes that the reality of how orders are routed and executed often is complex, and that it likely is not feasible to anticipate how the proposed requirement for a

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<sup>204</sup> See proposed Rule 613(c)(7)(i)(D).

unique order identifier would or would not apply to each different factual scenario. For example, members may often execute customer orders on a "riskless principal" basis,<sup>205</sup> rather than on an agency basis. The Commission preliminarily believes that it would not be practical or feasible to "link" through related unique order identifiers the customer order(s) and the member's proprietary order(s) from which the customer order is given an allocation. Rather, the Commission envisions that the member would create a new unique order identifier for each proprietary order, and that the manner in which the execution of the customer order would be "linked" with one (or more) proprietary order(s) (if at all) would be through the inclusion of the unique order identifier for the contra-side order(s) on the report of the execution of the customer order sent to the central repository.<sup>206</sup> However, in a situation where a member merely broke up a larger customer order into smaller orders and sent those orders, on an agency basis, to multiple markets for execution, the Commission preliminarily believes that the unique order identifier of the original customer order should carry through in some manner to the individual smaller orders that result when the original order is broken up. For example, it may be necessary to attach two unique order identifiers to an order – the original order identifier (i.e. parent order) and the individual smaller order identifier (i.e. child order). Alternatively, the unique order identifier of the parent order could be modified to carry through to the child orders (for example, the parent

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<sup>205</sup> For example, a member receives a customer order, and rather than sending the customer order as an agency order to an exchange or other marketplace to execute, the member creates an order for its proprietary account that it sends to an exchange or other marketplace to be executed. Once an execution occurs in the proprietary account, the member would then execute the customer order against its proprietary account. This process can be complicated by the member receiving and handling more than one customer order at a time, and creating one or more proprietary orders to send to one or more markets, and the manner in which the member allocates executions from its proprietary account among the customer orders.

<sup>206</sup> See proposed Rule 613(c)(7)(vi)(C).

order could have an identifier ABC and the child orders could have identifiers of ABC1 and ABC2).

The Commission preliminarily believes that a unique order identifier that is essentially transferred along with an order from origination through execution or cancellation is useful for a consolidated audit trail. The use of such an identifier would allow the SROs and the Commission to efficiently link all events in the life of an order and help create a complete audit trail across markets and broker-dealers that handle the order. In this manner, being able to link the parent order with the child orders through the unique order identifiers would allow for ease of tracking of the original parent order throughout its life. While the Commission believes that a unique order identifier is an important data element for the consolidated audit trail, the Commission is not proposing at this time to mandate the format of such an identifier or how the identifier would be generated.

The Commission requests comment on whether, and why, a unique order identifier that would stay with the order for the life of the order is useful or essential for an effective consolidated audit trail. In addition, the Commission requests comment on whether there is an alternative to a unique order identifier that would stay with the order for the life of the order. For example, would permitting each member or SRO that receives an order from another member or SRO to attach its own unique identifier to an order allow the SROs to efficiently link all events in the life of an order and ensure the creation of a complete audit trail across each market and broker-dealer that handled the order? The Commission requests comment on the feasibility and merits of the manner in which it proposes unique order identifiers be handled for riskless principal transactions. The Commission also requests comment on the feasibility and merits of requiring that a unique order identifier be attached to an order, as well as the multiple orders that

may result if the original order is subsequently broken up into several orders, in a manner that would permit regulators to trace the subsequent orders back to the original single order. The Commission also requests comment on the feasibility and merits of requiring that a unique order identifier be attached to an order that is the result of a combination of two more orders in a manner that would permit regulators to trace the combined order back to its component orders. The Commission further requests comment as to how unique order identifiers could be generated for both electronic and manual orders, and who should be responsible for generating them. Given the significant number of orders (including quotations) for which information would be required to be collected and provided to the central repository pursuant to the proposed Rule, the Commission requests comment on the feasibility of allowing unique order identifiers to be re-used. If unique order identifiers were to be re-used, at what point should that be allowed? Are there any concerns with re-use that should be addressed? Additionally, the Commission requests comment on whether it is feasible to require unique order identifiers if the consolidated audit trail is implemented in the proposed phased approach? For example, is it appropriate to require that national securities exchanges and national securities associations comply with this requirement before their members are required to do so?

The Commission also requests comment on procedures or safeguards market participants may wish to establish to ensure that unique order identifiers are routed and reported accurately. Further, the Commission requests comment on what systems modifications, if any, would be required in order to "tag" every order with a unique order identifier. Please respond to each question with specificity.

#### **iv. Routing**



The proposed Rule would require that the NMS plan require the collection and reporting to the central repository of all material information related to the routing of an order. Specifically, the proposed Rule would require the reporting of the following information each time an order is routed by the member or SRO that is doing the routing: (1) the unique order identifier; (2) the date on which an order was routed; (3) the exact time (in milliseconds) the order was routed; (4) the unique identifier of the broker-dealer or national securities exchange that routes the order; (5) the unique identifier of the broker-dealer or national securities exchange that receives the order; (6) the identity and nature of the department or desk to which an order is routed if a broker-dealer routes the order internally;<sup>207</sup> and (7) the material terms of the order.<sup>208</sup>

Further, the proposed Rule would require the collection and reporting by the SRO or member receiving an order of the following information each time a routed order is received: (1) the unique order identifier; (2) the date on which the order is received; (3) the time at which the order is received (in milliseconds); (4) the unique identifier of the broker-dealer or national securities exchange receiving the order; (5) the unique identifier of the broker-dealer or national securities exchange routing the order; and (6) the material terms of the order.<sup>209</sup>

This information would allow regulatory staff to easily identify each member or exchange that “touches” the order during its life, as well as the dates and times at which each member or exchange receives and reroutes the order, and any changes that may be made to the original terms of the order along the way. The Commission preliminarily believes that this

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<sup>207</sup> Internal routing information can be a critical element in assessing whether a member may be disadvantaging customer orders, either by trading ahead of customer orders, or by executing orders as principal at prices inferior to the NBBO.

<sup>208</sup> See proposed Rule 613(c)(7)(ii).

<sup>209</sup> See proposed Rule 613(c)(7)(iii).

information for orders that are routed would allow the Commission and SROs to efficiently track an order from inception through cancellation or execution.

The Commission requests comment as to whether such information regarding the routing of orders is useful or necessary for an effective consolidated audit trail. Should any additional information be included in the consolidated audit trail relating to routing? The Commission requests comment as to what systems modifications, if any, would be required to provide this information. Do members currently have, or have access to, this information? If not, what changes would need to be made to collect this information for existing accounts for submission to the central repository? Do commenters believe that it would be necessary to achieve the purposes of the proposed Rule to require information from each member or SRO that "touches" an order? Please explain with specificity why or why not. Is it feasible to require information relating to the routing of orders if the consolidated audit trail is implemented in the proposed phased approach? For example, is it appropriate to require that national securities exchanges and national securities associations comply with this requirement before their members are required to do so?

**v. Modification, Cancellation, and Execution**

The proposed Rule would require the NMS plan to require that information be reported to the central repository concerning any modifications to the material terms of an order or partial or full order cancellations. The national securities exchange, national securities association, or member handling the order at the time would be required to immediately report to the central repository the following information: (1) the unique order identifier, (2) the date and time (in milliseconds) that an order modification or cancellation was originated or received; (3) the identity of the person responsible for the modification or cancellation instruction; (4) the price

and remaining size of the order, if modified; and (5) other modifications to the material terms of the order.<sup>210</sup> Information pertaining to order modifications and cancellations would assist the Commission and SROs in identifying all changes made to an order and the persons and broker-dealers responsible for the changes.

The proposed Rule also would require the following information on full or partial executions of orders to be collected and reported to the central repository: (1) the unique order identifier; (2) the execution date; (3) the time of execution (in milliseconds); (4) the capacity of the entity executing the order (whether principal, agency, or riskless principal); (5) the execution price; (6) the size of the execution; (7) the unique identifier of the national securities exchange or broker-dealer executing the order,<sup>211</sup> and (8) whether the execution was reported pursuant to an effective transaction reporting plan or pursuant to the OPRA Plan, and the time of such report.<sup>212</sup>

The Commission preliminarily believes that the required execution information, in combination with the proposed information pertaining to order receipt or origination, modification, or cancellation, would provide regulators with a comprehensive, near real time view of all stages and all participants in the life of an order. The proposed Rule would allow the Commission and SROs to identify, for a particular transaction, every member and national securities exchange involved in the receipt or origination, routing, modification, and execution (or cancellation) of the order. This order information, including the readily accessible customer information, should help regulators investigate suspicious trading activity in a more timely manner than currently possible.

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<sup>210</sup> See proposed Rule 613(c)(7)(iv).

<sup>211</sup> Each national securities exchange and national securities association would have its own unique identifier, as well as each broker-dealer (member) (see supra Section III.D.1.ii.).

<sup>212</sup> See proposed Rule 613(c)(7)(v).

Additionally, the requirement to report whether and when the execution of the order was reported to the consolidated tape<sup>213</sup> should allow regulators to more efficiently evaluate certain trading activity. For example, trading patterns of reported and unreported transactions may cause the staff of an SRO or the Commission to make further inquiry into the nature of the trading to determine whether the public was receiving accurate and timely information regarding executions and that market participants were continuing to comply with the trade reporting obligations under SRO rules. Similarly, patterns of reported and unreported transactions could be indicia of market abuse, including failure to obtain best execution for customer orders or possible market manipulation. Being able to more efficiently compare the consolidated order execution data with the trades reported to the consolidated tape could thus be an important component of overall surveillance activity.

As discussed above, the Commission recognizes that the execution of orders often is complex.<sup>214</sup> For example, a customer order may be executed on a riskless principal basis. When a member receives a customer order, rather than sending the customer order as an agency order to an exchange or other marketplace for execution, the member creates an order for its proprietary account that it sends to an exchange or other marketplace to be executed. Once an execution occurs in the proprietary account, the member would then execute the customer order against its proprietary account. This process can be complicated by the member receiving and handling more than one customer order at a time, and creating one or more proprietary orders to

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<sup>213</sup> Id. See also infra Section III.F.1. for a discussion of the requirement in proposed Rule 613(e)(5) that the NMS plan require the central repository to receive and retain on a current and continuing basis (i) the national best bid and national best offer for each NMS security, (ii) transaction reports reported pursuant to a transaction reporting plan filed with the Commission pursuant to, and meeting the requirements of, Rule 601 of Regulation NMS, and (iii) last sale reports reported pursuant to the OPRA Plan.

<sup>214</sup> See supra notes 205-206 and accompanying text.

send to one or more markets, and the manner in which the member allocates executions from its proprietary account among the customer orders. Each proprietary order would have a unique order identifier that is different from, and not linked to, the unique order identifier for the original customer order. How should the reporting to the central repository of the execution of the proprietary orders and the customer order be handled? As noted above, the Commission envisions that the manner in which the execution of the customer order would be "linked" with one (or more) of the proprietary order(s) would be through the inclusion of the unique order identifier for the contra-side order(s) on the report of the execution of the customer order sent to the central repository.<sup>215</sup> Is this practical? Is there another method by which to link the execution of the customer order to the proprietary orders? Is it necessary to do so to achieve the purposes of the consolidated audit trail?

The Commission requests comment on whether the information proposed to be collected and reported would be sufficient to create a complete and accurate audit trail. Is there additional information that should be collected and reported? If yes, please describe the information and the value its collection and reporting would add to the consolidated audit trail.

## **2. Information to be Collected Other Than in Real Time**

While the majority of order and execution information would be required to be transmitted to the central repository on a real time basis, the Commission recognizes that this may not be practical or feasible for all information because the information may not be known at the time of the reportable event.<sup>216</sup> Thus, the Commission is proposing that certain information be transmitted to the central repository promptly after the national securities exchange, national

<sup>215</sup> See supra note 206 and accompanying text.

<sup>216</sup> For example, a member may receive an order during the day from an advisory customer but not know to which sub-accounts to allocate execution of the order until later in the day.

securities association, or member receives the information, but in no instance later than midnight of the day that the reportable event occurs or the national securities exchange, national securities association, or member receives such information.<sup>217</sup> The Commission preliminarily believes that this proposed time frame would provide sufficient time for an exchange, association, or a member to obtain the information required to be reported while still allowing regulators to access the information for regulatory purposes on a more timely basis than today.

Each national securities exchange, national securities association and their members would be required to report the account number for any subaccounts to which an execution is allocated.<sup>218</sup> By requiring that this data be included in the consolidated audit trail, regulators would be able to more easily identify the "ultimate" customer for the trade. The Commission preliminarily believes that it would be useful to know the account number as well as the required information on the beneficial owner. For example, a person or groups of persons could trade through a single account or numerous accounts. Because individual traders may use multiple accounts at multiple broker-dealers, being able to identify the beneficial owner of the underlying accounts aids in the identification and investigation of suspicious trading activity. Similarly, traders may seek to hide manipulative activity from regulatory oversight by trading anonymously through omnibus accounts. In those instances, linking the trade to the individual trader requires the market center to be able to identify both the accounts trading and the beneficial owner or owners of those accounts to determine what person or group of persons is directing the specific trades at issue. Requiring the identity of the ultimate customer electronically to be attached to each order would make this information easily accessible and searchable and thus would greatly

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<sup>217</sup> See proposed Rule 613(c)(4).

<sup>218</sup> See proposed Rule 613(c)(7)(vi)(A).

improve the usefulness of audit trail information for purposes of effective enforcement and cross-market surveillance.

Each national securities exchange, national securities association and their members also would be required to report the unique identifier of the clearing broker or prime broker for the transaction, if applicable, and the unique order identifier of any contra-side order.<sup>219</sup> Finally, if the execution is cancelled, a cancelled trade indicator would be required to be reported. In addition, the proposed Rule also would require the reporting of any special settlement terms for the execution, if applicable; short sale borrower information and identifier; and the amount of a commission, if any, paid by the customer, and the unique identifier of the broker-dealer(s) to whom the commission is paid.<sup>220</sup>

Broker-dealers have a duty of best execution.<sup>221</sup> Since commissions can be charged

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<sup>219</sup> See proposed Rule 613(c)(7)(vi)(B) and (C).

<sup>220</sup> See proposed Rule 613(c)(7)(vi)(D), (E), and (F).

<sup>221</sup> A broker-dealer has a legal duty to seek to obtain best execution of customer orders. See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 269-70, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998); Certain Market Making Activities on Nasdaq, Securities Exchange Act Release No. 40900 (Jan. 11, 1999) (settled case) (citing Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971); Arleen Hughes, 27 SEC 629, 636 (1948), aff'd sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949)). See also Order Execution Obligations, Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) ("Order Handling Rules Release"). A broker-dealer's duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated in SRO rules and, through judicial and Commission decisions, the antifraud provisions of the federal securities laws. See Order Handling Rules Release, 61 FR at 48322. See also Newton, 135 F.3d at 270. The duty of best execution 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. Newton, 135 F.3d at 270. Newton also noted certain factors relevant to best execution - order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. Id. at 270 n.2 (citing Payment for Order Flow, Exchange Act Release No. 33026 (Oct. 6, 1993), 58 FR 52934, 52937-38 (Oct. 13, 1993) (Proposed Rules)). See In re E.F. Hutton & Co., Securities Exchange Act Release No. 25887 (July 6, 1988). See also Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, 55008-55009 (November 2, 1994) ("Approval of

either explicitly through a separate fee or implicitly in the transaction price, the lack of easily accessible commission fee data alongside transaction price data may make it hard to identify the “all-in” price of execution and, thus, hard to determine whether the obligation to seek best execution was met.<sup>222</sup> In addition, broker-dealers also must comply with just and equitable principles of trade under NASD rules that require them to charge fair commissions and mark-ups (mark-downs), and the lack of easily accessible commission fee data may make it hard to determine whether just and equitable principles of trade have been observed.<sup>223</sup> Also, FINRA rules prohibit certain quid pro quo arrangements in the distribution of IPOs.<sup>224</sup>

The Commission requests comment on the usefulness and necessity of requiring the reporting of each of these items of information to achieve the stated objectives of the consolidated audit trail. Are there practical difficulties associated with providing this information as proposed? Is there additional information that would be useful or necessary in this regard? For example, the proposed Rule would require the reporting of a cancelled trade indicator, for executions that are cancelled. Should the proposed Rule require separate identification of trades that are broken pursuant to the rules of the applicable SRO at the request

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Payment for Order Flow Final Rules”). See also Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (“NMS Adopting Release”), at 37537 (discussing the duty of best execution).

<sup>222</sup> The term “all-in” price is intended to capture the total costs for executing a trade.

<sup>223</sup> See FINRA Rule 2010 and IM-2440-1.

<sup>224</sup> See FINRA Rule 5130. The Rule ensures that: (1) FINRA members make bona fide public offerings of securities at the offering price; (2) members do not withhold securities in a public offering for their own benefit or use such securities to reward persons who are in a position to direct future business to members; and (3) industry insiders, including FINRA members and their associated persons, do not take advantage of their insider position to purchase “new issues” for their own benefit at the expense of public customers. For example, information on commissions could help detect a transaction in the secondary market between an underwriter and an investor at an excessively high commission rate that is a “quid pro quo” for the underwriter allocating shares in a “hot” IPO to the investor.



of one party to a transaction or upon the SRO's own motion, and trades that are cancelled by mutual agreement of the parties? Why or why not? The Commission also requests comment on whether the proposed requirement to report the identity of the clearing broker would provide sufficient information on "give-up" arrangements,<sup>225</sup> or whether additional information should be required to be reported.

The Commission requests comment on the proposed time frame for reporting of this information. The Commission is proposing that the information not required to be reported in real time be reported promptly after receipt, but in no event later than midnight on the day the reportable event occurs or the exchange, association, or member receives the information. While one of the objectives of the proposed Rule is to collect data on a real time basis, the Commission understands that certain information may not be available at the time of the reportable event (e.g., the execution or cancellation). The Commission, however, believes such information should be provided promptly after receipt, meaning as soon as possible given the capabilities of a market participant's systems. While the Commission is proposing that the information be reported promptly, the proposed Rule also would provide an objective time limit for providing the information – no later than midnight on the day the event occurs or the information is received by the exchange, association, or member. Is the proposed time frame reasonable with respect to the information that would be required to be reported? Should the proposed Rule only require that information be reported promptly after receipt? How should promptly be measured?

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<sup>225</sup>

In a typical give-up arrangement, a broker-dealer that is not a member of an exchange (Broker-dealer A) may route the order to another broker-dealer that is a member of an exchange (Broker-dealer B) for execution on that exchange. If Broker-dealer B is not also a clearing member of the exchange, it may "give-up" the execution of that order to another broker-dealer that is a clearing member of that exchange (Broker-dealer C). Further, there may be a corresponding "flip" of the trade from Broker-dealer C's account to the account of the broker-dealer that is the clearing firm for Broker-dealer A.

Alternatively, should the proposed Rule only require that information not available at the time the reportable event occurs be reported no later than midnight on the day the information was received? How would this standard impact the usefulness of the consolidated audit trail?

**E. Clock Synchronization**

The Commission believes that clock synchronization is necessary to ensure an accurate audit trail, given the number of market participants with internal order handling and trading systems that would be reporting information to the central repository. Therefore, proposed Rule 613(d) would provide that the NMS plan filed with the Commission include a requirement that each national securities exchange and national securities association, and their members, synchronize their business clocks that are used for the purposes of recording the date and time of any event that must be reported under the proposed Rule. The proposed Rule would require each exchange, FINRA, and their members to synchronize their clocks to the time maintained by the National Institute of Standards and Technology ("NIST"), consistent with industry standards.<sup>226</sup> Exchanges, associations, and the members would be required to synchronize their business clocks in accordance with these requirements within four months after effectiveness of the NMS plan.<sup>227</sup>

The Commission is not proposing to set a standard within which the clocks must be synchronized to the NIST (e.g., to within one second of the NIST clock), in recognition of how quickly technology can improve and increase the speed at which orders are handled and executed. Rather, the Commission is proposing that the clocks be synchronized "consistent with industry standards." The exchanges and FINRA would be able, however, to set a limit in the NMS plan to be filed with the Commission. Also, in recognition of the pace at which technology

<sup>226</sup> See proposed Rule 613(d)(1).

<sup>227</sup> See proposed Rule 613(a)(3)(ii).

improves, the proposed Rule provides that the NMS plan shall require each national securities exchange, national securities association, and its respective members to annually evaluate the actual synchronization standard adopted to consider whether it should be shortened, consistent with changes in industry standards.<sup>228</sup> When engaging in this annual evaluation, exchanges, associations, and members could take into account the feasibility of shortening the time standard, and whether shortening the standard would allow for the conveyance of additional meaningful information to the consolidated audit trail.

The Commission requests comment on whether this approach is practical and would provide for sufficient flexibility in determining how closely to synchronize clocks. Is the proposed Rule's requirement that each exchange, association, and member synchronize its clocks in accordance with the time maintained by NIST reasonable? To what extent do SROs and their members currently synchronize clocks? Please answer with specificity. Would synchronization as proposed require significant systems modifications on behalf of national securities exchanges, national securities association, or their respective members? Is it reasonable to require clocks to be synchronized with the time maintained by NIST within a time frame that is "consistent with industry standards"? Is there another standard that should be used by the Commission? The Commission also requests comment on the feasibility of requiring the exchanges, FINRA, and their members to comply with these requirements within four months of effectiveness of the NMS plan.

#### **F. Central Repository**

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<sup>228</sup> See proposed Rule 613(d)(2).

The proposed Rule would require that the NMS plan provide for the creation and maintenance of a central repository, which would be a facility of each exchange and FINRA.<sup>229</sup> The central repository would be jointly owned and operated by the exchanges and FINRA, and the NMS plan would be required to provide, without limitation, the Commission and SROs with access to, and use of, the data reported to and consolidated by the central repository for the purpose of performing their respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations. Each of the exchanges and FINRA would be a sponsor of the plan,<sup>230</sup> and as such would be responsible for selecting a plan processor to operate the central repository.<sup>231</sup>

The Commission requests comment on the need for a central repository to receive and retain the consolidated audit trail information. Are there alternatives to creating a central repository for the receipt of order audit trail information? The Commission also requests comment on whether it is practical or appropriate to require the exchanges and FINRA to jointly own and operate the central repository.

**1. Responsibilities of Central Repository to Collect, Consolidate, and Retain Information**

The central repository would be responsible for the receipt, consolidation, and retention of all data submitted by the national securities exchanges, national securities associations and their members pursuant to the proposed Rule and the NMS plan.<sup>232</sup> Further, the central repository would be required to collect from the central processors and retain on a current and

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<sup>229</sup> See proposed Rule 613(e)(1).

<sup>230</sup> See *supra* note 173 for a definition of a plan sponsor in Rule 600(a)(70) of Regulation NMS, 17 CFR 242.600(a)(70).

<sup>231</sup> See *infra* Section III.I. for a definition and discussion of the plan processor.

<sup>232</sup> See proposed Rule 613(e)(1).

continuous basis the NBBO for each NMS security, transaction reports reported pursuant to an effective transaction reporting plan filed with the Commission pursuant to, and meeting the requirements of, Rule 601 of Regulation NMS, and last sale reports reported pursuant to the OPRA Plan filed with the Commission pursuant to, and meeting the requirements of, Rule 608 of Regulation NMS.<sup>233</sup> The central repository would be required to maintain this NBBO and transaction data in a format compatible with the order and event information reported pursuant to the proposed Rule.

This requirement is intended to allow SRO and Commission staff to easily search across order, NBBO, and transaction databases. The Commission preliminarily believes that having the NBBO information in a format compatible with the order audit trail information would be useful for enforcing compliance with federal securities laws, rules and regulations. The NBBO is used by regulators to evaluate members for compliance with numerous regulatory requirements, such as the duty of best execution or Rule 611 of Regulation NMS.<sup>234</sup> Regulators would be able to compare order execution information to the NBBO information on a more timely basis because the order and execution information would be available on a real time basis and all of the information would be available in a compatible format in the same database. The SROs also may enjoy economies of scale by adopting standard cross-market surveillance parameters for

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<sup>233</sup> See proposed Rule 613(e)(5). The central repository would be required to retain the information collected pursuant to subparagraph (c)(7) and (e)(5) of the proposed Rule in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years. The information would be required to be available immediately, or if immediate availability could not reasonably and practically be achieved, any search query would be required to begin operating on the data not later than one hour after the search query is made. See proposed Rule 613(e)(6).

<sup>234</sup> See Rule 611 of Regulation NMS, 17 CFR 242.611. See also ISE Rule 1901, NYSE Arca 6.94, and Phlx Rule 1084.

these types of violations. This information also would be available to the Commission to assist in its oversight efforts.

The Commission also preliminarily believes that requiring the central repository to collect and retain in its database the transaction information in a format compatible with the order execution information would aid in monitoring for certain market manipulations. As discussed above, the proposed Rule would require that each report of the execution (in whole or in part) of an order sent to the central repository include a notation as to whether the execution was reported to the consolidated tape pursuant to an effective transaction reporting plan or the OPRA Plan.<sup>235</sup> This requirement should allow regulators to more efficiently evaluate certain trading activity. For example, trading patterns of reported and unreported trades may cause the staff of an SRO to make further inquiry into the nature of the trading to determine whether the public was receiving accurate and timely information regarding executions and that market participants were continuing to comply with the trade reporting obligations under SRO rules. Similarly, patterns of reported and unreported transactions could be indicia of market abuse, including failure to obtain best execution for customer orders or possible market manipulation. Being able to more efficiently compare the consolidated order execution data with the trades reported to the consolidated tape could thus be an important component of overall surveillance activity.

The Commission requests comment on the usefulness or necessity of requiring the central repository to collect and retain in a format compatible with the order audit trail information the NBBO and transaction report information to help achieve the stated objectives of the consolidated audit trail. Do commenters believe that it is important for achieving the purposes of

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<sup>235</sup> See supra Section III.D.1.v.

the consolidated audit trail? If so, why? If not, why not? What are the advantages and disadvantages of maintaining transaction information separately from order and execution data included in the consolidated audit trail? Should the transaction information be included in the consolidated audit trail report? The Commission requests comment on whether the requirement that the transaction and NBBO information be maintained in a format compatible with the order information is practical. Would this requirement achieve the goal of helping SRO and Commission staff conduct searches and run surveillances across databases?

The Commission has recently required that issuers report certain data in interactive data format such as XBRL.<sup>236</sup> This proposal does not specify any particular or required data format, but allows the SROs to select a data format. Should the Commission require that the data be transmitted or stored in any particular format? What are the relative merits of flat data files, relational data files, and interactive data files? What other formats should be considered? In what format can the SROs and their members efficiently transmit data? In what format would the data required in the proposal be most easily accessed?

The proposed Rule would require the NMS plan to require the central repository to retain the information collected pursuant to subparagraph (c)(7) and (e)(5) of the proposed Rule in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years. The information would be required to be available immediately, or if immediate availability could not reasonably and practically be achieved, any search query would be required to begin operating on the data not later than one hour after the search query is made.<sup>237</sup>

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<sup>236</sup> See Securities Act Release No. 9002 (January 30, 2009), 74 FR 6776 (February 10, 2009) (Interactive Data to Improve Financial Reporting adopting release) (File No. S7-11-08).

<sup>237</sup> See proposed Rule 613(e)(6).

The Commission preliminarily believes that the information (or the results of a query searching the information) should generally be available immediately. However, the Commission recognizes that the results of an electronic search query may not be immediately available because, for instance, the system must check an extremely large number of records to answer the query or the system may need to retrieve records from electronically archived data. In the case of archived data, the Commission preliminarily proposes requiring that the search query would need to begin operating on the data not later than one hour after the query is made. The Commission requests comment as to whether one hour would be reasonable amount of time to allow for accessing archived data. Under current technological limitations, how long should it take to access, in an electronic query with no manual intervention, archived data of the type to be held by the central repository? The Commission also requests comment on whether it should mandate a time standard, such as one hour, in the proposed Rule. Further, the Commission requests comment on whether the central repository should be required to retain this information for longer or shorter than five years. The Commission also requests comment on the cost impact of these proposed record retention requirements. For example, could comparable functionality be obtained at lower cost with a different standard (for example, what would be the cost comparison for one hour versus two hours)?

**2. Access to Central Repository and Consolidated Audit Trail Information and Confidentiality of Consolidated Audit Trail Information**

Each national securities exchange and national securities association, as well as the Commission, would have access to the central repository for purposes of performing its respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations. Such access would include access to all systems of the central repository, and



access to and use of the data reported to and consolidated by the central repository.<sup>238</sup> The proposed Rule also would require that the NMS plan provide that such access to and use of such data by each exchange, association, and the Commission for the purpose of performing its regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations shall not be limited.<sup>239</sup> In addition, the proposed Rule would require that the NMS plan include a provision requiring the creation and maintenance by the central repository of a method of access to the consolidated data.<sup>240</sup> This method of access would be required to be designed to include search and reporting functions to optimize the use of the consolidated data.

The Commission's access to the central repository, and access to and use of the data maintained by the central repository, for purposes of performing the Commission's responsibilities under the federal securities laws, rules, and regulations could not be limited in any way.<sup>241</sup> The Commission requests comment as to whether the proposed Rule as proposed would accomplish this objective? If not, why not? If not, please provide comment as to an alternative or additional way to accomplish this objective. The Commission also requests comment on the advantages or disadvantages of Commission ownership or co-ownership of the data maintained by the central repository.

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<sup>238</sup> See proposed Rule 613(e)(2)

<sup>239</sup> Id.

<sup>240</sup> See proposed Rule 613(e)(3).

<sup>241</sup> As noted above, the central repository would be a facility of each exchange and FINRA (see supra note 229 and accompanying text), and as such, subject to the Commission's recordkeeping and inspection authority. See, e.g., Section 17 of the Exchange Act, 17 U.S.C. 78q. Further, any amendment to the NMS plan would be filed with the Commission pursuant to Rule 608 of Regulation NMS, and would not become effective unless approved by the Commission or otherwise as permitted in accordance with the requirements of Rule 608. See proposed Rule 613(a)(5), and Rule 608(a) and (b) of Regulation NMS, 17 CFR 242.608(a) and (b).

As discussed above, the proposed Rule would require the reporting of customer information, as well as information about "live" orders, to the central repository on a real time basis. The Commission recognizes the sensitivity of this information, and believes that maintaining the confidentiality of, and limiting the use of, the data is essential. Without such protections, broker-dealers and the investing public could be at risk for security breaches that would potentially have a detrimental impact on their financial condition, as well as their trading activity and the markets. The consolidated data also would include information about members' trading activities on competitors' markets. The Commission therefore is proposing several requirements designed to limit access to, and help assure confidentiality and proper use of, the information.

As noted above, the proposed Rule would limit the use of the consolidated data by the SROs for purposes of performing their respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations.<sup>242</sup> This proposed restriction would not prevent any SRO from using the data that it individually collects and provides to the central repository pursuant to the proposed Rule for other purposes as permitted by applicable law, rule or regulation.

The Commission requests comment as to whether access to the consolidated audit trail information should be limited to the SROs and the Commission, or whether there should be other access allowed. For example, should SROs or the central repository be allowed to make the data available to third parties, such as for academic research? If so, should the data be permitted to be sold to help offset costs? By SROs? By the central repository? If so, should there be set

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<sup>242</sup> See proposed Rules 613(e)(2). See also proposed Rule 613(e)(4)(i) (requiring in part that the NMS plan include a provision requiring all plan sponsors and their employees to agree not to use the consolidated data for any purpose other than surveillance and regulatory purposes).

parameters? If the data were made available to third parties, what protections should be put in place to ensure the confidentiality of the data? Are there particular data elements that are more sensitive and should not be sold to help ensure the privacy of any individual and proprietary information? Are there particular data elements that would pose fewer concerns if released on a significant time lag? How long would such a time lag need to be? What other concerns might arise from the use of the data for non-regulatory purposes? Would use of the data provide certain market participants with undue information advantages over other market participants, increasing informational asymmetry in the markets? Would the provision of market data to third parties affect the willingness of market participants to trade in the U.S. markets? On the other hand, would enhanced surveillance of the markets as a result of the consolidated audit trail attract additional trading volume to the U.S. markets? What would be the implications, if any, under the financial privacy provisions of the Gramm-Leach-Bliley Act?<sup>243</sup> The Commission also requests comment as to whether, and to what extent, other regulators, such as the Commodity Futures Trading Commission, should have access to the data? For instance, to what extent do commenters believe it would be beneficial for the Commission to work with other regulators to collectively share information each regulator has with respect to products and trading activity under its jurisdiction, to help the Commission and other regulators carry out their respective oversight of products and trading activity within their own jurisdiction? Would such sharing of information help the Commission better understand the impact of trading in other markets on trading activity and products within the Commission's jurisdiction?

The Commission also requests comment on the feasibility of, and need for, a method of access to the consolidated data that includes search and reporting functions. In addition, the

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<sup>243</sup> 15 U.S.C. 6801-6809.

Commission requests comment as to whether, in addition to requiring the central repository to provide a method of access, the central repository should be required to bear the cost of making available the raw order data received by the central repository, for purposes of using that data to perform regulatory functions. Commenters are requested to provide cost estimates for the provision of this data by the central repository to the SROs and the Commission.

Proposed Rule 613(e)(4)(i) also would require that the NMS plan include policies and procedures, including standards, to be used by the plan processor to ensure the security and confidentiality of all information submitted to, and maintained by, the central repository. The plan sponsors, and employees of the plan sponsors and central repository, would be required to agree to use appropriate safeguards to ensure the confidentiality of such data, and not to use such data for other than for surveillance regulatory purposes.<sup>244</sup> The Commission is not proposing to mandate the content or format of the policies and procedures and standards that would be required. Rather, the Commission believes that the SROs themselves are in the best position to determine how best to implement this requirement.

The Commission requests comment generally on the issue of appropriate safeguards to be put in place by the SROs and the central repository to help ensure confidentiality. Are there specific safeguards that the SROs and the central repository could use to ensure the confidentiality and appropriate usage of the data collected and submitted pursuant to the proposed Rule? For example, should the proposed Rule require that SROs put in place specific information barriers or other protections to help ensure that data is used only for regulatory purposes? Should there be an audit trail of the SROs' personnel access to, and use of,

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<sup>244</sup> See proposed Rule 613(e)(4)(i). However, a plan sponsor would be permitted to use the data that it submits to the central repository for regulatory, surveillance, commercial, or other purposes as otherwise permitted by applicable law, rule or regulation. *Id.*

information in the central repository to help monitor for compliance with appropriate usage of the data? Should the requirement that the NMS plan include policies and procedures to be used by the plan processor to ensure the security and confidentiality of information submitted to, and maintained by, the central repository be expanded to include the content of any searches or queries performed by the SROs or the Commission on the data? What should be required? Please be specific in your answer.

The Commission would establish appropriate protections within the agency to help ensure the confidentiality of the records.

### **3. Reliability of Data Collected and Consolidated**

An audit trail is only as reliable as the data used to create it. The Commission believes that it is critical to the integrity of the consolidated audit trail that the data submitted by the national securities exchanges, national securities associations and their members be submitted in a timely manner, and be accurate and complete. Proposed Rule 613(e)(4)(ii) therefore would require that the NMS plan include policies and procedures, including standards, for the plan processor to use to help ensure the integrity of the information submitted to the central repository. Specifically, the policies and procedures would be required to be designed to help ensure the timeliness, accuracy, and completeness of the data provided to the central repository by the SROs and their members. The Commission expects that these policies and procedures would include the creation of certain validation parameters that would need to be met before data would be accepted into the central repository.

The proposed Rule also would require that the NMS plan include policies and procedures, including standards, governing how and when the plan processor should reject data provided to the central repository that does not meet these validation parameters. Further, the

proposed Rule would require the NMS plan to include policies and procedures that would govern how to re-transmit data that was rejected once it has been corrected, and how to help ensure that information is being resubmitted.<sup>245</sup> The Commission expects that re-transmitted data would also be subject to the validation parameters to assure that the initial problem(s) with the data has been corrected.

In addition, the proposed Rule would require that the NMS plan include policies and procedures to ensure the accuracy of the consolidation of the data by the plan processor provided to the central repository. Again, the Commission notes that it is not proposing to mandate the form and content of such policies and procedures. Rather, it believes the SROs would be in a better position to determine how best to implement this requirement. The Commission requests comment on these proposed requirements. Is this approach practical to ensure the integrity of the data? Are there any alternative methods that would achieve the same purpose that are preferable? How much latency would result from a validation procedure?

As noted above, the Commission believes it is critical to the integrity of the consolidated audit trail that data submitted to the central repository be submitted in a timely manner and be accurate and complete. To support this objective, as discussed below in Sections III.H.1 and III.H.2, the proposed Rule also would require the NMS plan to include mechanisms to ensure compliance by the plan sponsors and their members with the requirements of the plan.<sup>246</sup> The purpose of the provisions, with respect to SRO compliance, is to require the SROs themselves to implement a method to help ensure compliance with the NMS plan, as is required by Rule 608 of Regulation NMS. Although the Commission is not proposing to mandate the format of the mechanism, the Commission preliminarily believes that it could include the imposition of penalties

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<sup>245</sup> See proposed Rule 613(e)(4)(iii).

<sup>246</sup> See proposed Rule 613(h)(3) and Rule 613(g)(4).

on an SRO in the event an SRO failed to comply with any provision of the NMS plan. Further, the Commission preliminarily believes that the mechanism to help ensure compliance by members could include the imposition of fines on a member, subject to the rules of the SRO of which it is a member, in the event a member failed to comply with the requirements of the NMS plan or the SRO's rules.

#### **G. Surveillance**

Proposed Rule 613(f) would require each national securities exchange and national securities association subject to the proposed Rule to develop and implement a surveillance system, or enhance existing surveillance systems, reasonably designed to make use of the consolidated information contained in the consolidated audit trail. The proposed Rule would require each national securities exchange and national securities association to implement such new or enhanced surveillance system within fourteen months after effectiveness of the NMS plan.<sup>247</sup> Currently, SROs are required to surveil members' trading activity for compliance with federal securities laws, rules, and regulations, such as rules relating to front running, trading ahead, market manipulation, and quote rule violations, as well as other Commission and SRO rules. The Commission understands that although SROs carry out certain surveillances in real time, such as for looking for pricing anomalies or other indicators of erroneous transactions, most surveillance currently is not done on a real time basis. The Commission preliminarily believes the systems that carry out this surveillance should be updated, or new systems should be

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<sup>247</sup> See proposed Rule 613(a)(3)(iv). The SROs would be required to begin reporting information to the central repository within twelve months after effectiveness of the NMS plan. The Commission is proposing to allow SROs two additional months (for a total of fourteen months) to update their surveillance systems to allow for testing of new surveillances for some period of time after the SROs begin providing information. The Commission requests comment on this time period. Should it be longer? Shorter? If so, why?

created, to make use of the consolidated audit trail information that would be generated and maintained by the central repository, otherwise the purpose of requiring a consolidated audit trail would not be achieved.

The Commission generally requests comment on this proposed requirement, as well as the proposed timing for compliance. To what extent do SROs currently conduct surveillance of trading on their markets on a real time basis? To what extent could SROs make effective use of the proposed consolidated information to enhance or update their existing surveillance and regulation? How would SROs be able to enhance or change their existing surveillance and regulation to make use of the proposed consolidated information? Would the benefits of surveillance that the SROs would be able to undertake be justified by the costs of providing information to the central repository on a real time basis? Under the proposed Rule, national securities exchanges and national securities associations would be required to implement or enhance their surveillance systems prior to their members being required to provide information pursuant to the proposed Rule. Do commenters believe that surveillance systems should be in place in advance of member compliance or should these requirements happen simultaneously, or otherwise?

The Commission is not proposing at this time to require coordinated surveillance across exchanges and FINRA. Rather, the Commission intends that each SRO would be responsible for surveillance of its own market and its own members using the consolidated audit trail information. The Commission would, however, encourage any coordinated surveillance efforts by the SROs, such as through a plan approved pursuant to Rule 17d-2 under the Exchange



Act,<sup>248</sup> or a regulatory services agreement among one or more SROs. The Commission requests comment on whether it should undertake to require coordinated surveillance.

## H. Compliance with the NMS Plan

### 1. Exchanges and Associations

Any failure by a national securities exchange or national securities association that is a sponsor of the NMS plan to comply with the requirements of the NMS plan would undermine the effectiveness of the proposed Rule. Therefore, the Commission would consider full compliance by these entities with the NMS plan of the utmost importance. To this end, the proposed Rule would provide that each national securities exchange and national securities association shall comply with the provisions of the NMS plan of which it is a sponsor submitted pursuant to the proposed Rule and approved by the Commission.<sup>249</sup> In addition, the proposed Rule would provide that any failure by a national securities exchange or national securities association to comply with the provisions of the NMS plan of which it is a sponsor could be considered a violation of the proposed Rule.<sup>250</sup> For example, a failure to provide required information to the central repository, a failure to develop and implement a surveillance system or enhance existing surveillance systems reasonably designed to make use of the consolidated data in the central repository, or any limitation on the ability of an SRO or the Commission to access and use the data maintained by the central repository for regulatory purposes would violate the proposed Rule. The

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<sup>248</sup> 17 CFR 240.17d-2. For example, the exchanges have entered into an agreement for the allocation of regulatory responsibilities pursuant to Rule 17d-2 under the Exchange Act concerning the surveillance, investigation, and enforcement of insider trading rules pertaining to members of the NYSE and FINRA who are also members of at least one of the other participating SROs. See Securities Exchange Act Release No. 58806 (File No. 4-566) (October 17, 2008), 73 FR 63216 (October 23, 2008).

<sup>249</sup> See proposed Rule 613(h)(1)

<sup>250</sup> See proposed Rule 613(h)(2).

Commission recognizes that its staff, and the SRO staff, may have to undertake certain technical actions to access the data, such as arranging for a live feed, querying the system, or upgrading systems to be able to receive the data. The Commission preliminarily would not view having to take such technical actions, by themselves, as a limitation. The Commission notes that the proposed Rule would require the central repository to maintain the data in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years. The information would be required to be available immediately, or if immediate availability could not reasonably and practically be achieved, any search query would be required to begin operating on the data not later than one hour after the search query is made.<sup>251</sup> The Commission requests comment on whether other types of technical actions should not be viewed as an impermissible limitation on access. The Commission further notes that Rule 608(c) under the Exchange Act provides that “[e]ach self-regulatory organization shall comply with the terms of any effective national market system plan of which it is a sponsor or a participant.”<sup>252</sup> Thus, under this proposed Rule, the Commission may take any action authorized under the Exchange Act to discipline national securities exchanges and national securities associations for failure to comply with a rule under the Exchange Act.

The proposed Rule also would require that the NMS plan include a mechanism to ensure compliance by the sponsors with the requirements of the plan.<sup>253</sup> The purpose of this provision is to require the SROs themselves to implement a method to help ensure compliance with the NMS plan, as is required by Rule 608 of Regulation NMS. Although the Commission is not proposing

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<sup>251</sup> See proposed Rule 613(e)(6) and supra note 237 and accompanying text.

<sup>252</sup> 17 CFR 242.608(c)

<sup>253</sup> See proposed Rule 613(h)(3).

to mandate the format of the mechanism, the Commission preliminarily believes that it could include the imposition of penalties on an SRO in the event an SRO failed to comply with any provision of the NMS plan. The Commission request comments on the types of sanctions or penalties that would be appropriate for the plan sponsors to levy for failure of an SRO to comply with the terms of the NMS plan.

## 2. Members

Any failure by a member of a national securities exchange or national securities association that is a sponsor of the NMS plan to collect and provide to the central repository the required audit trail information also would undermine the effectiveness of the proposed Rule. Therefore, the Commission would consider full compliance by these entities with the NMS plan of the utmost importance.

To implement the proposed requirement that the NMS plan require the submission of certain information to the central repository by the members of the exchange and association sponsors of the plan, each exchange and association would be required to file with the Commission pursuant to Section 19(b)(2) of the Exchange Act<sup>254</sup> and Rule 19b-4 thereunder,<sup>255</sup> a proposed rule change to require its members to comply with the requirements of the proposed Rule and the NMS plan.<sup>256</sup> The SROs would be required to file these proposed rule changes by 120 days after approval of the proposed Rule. The Commission preliminarily believes that this proposed time frame would provide the SROs sufficient time to file their proposed rule changes

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<sup>254</sup> 15 U.S.C. 78s(b)(2).

<sup>255</sup> 17 CFR 240.19b-4.

<sup>256</sup> See proposed Rule 613(g)(1). This provision in the proposed Rule echoes the requirement contained in Rule 608 that provides "each self-regulatory organization also shall, absent reasonable justification or excuse, enforce compliance with any such plan by its members and persons associated with its members. 17 CFR 242.608(c).

after the NMS plan has been approved,<sup>257</sup> as the SRO rule filings would be substantially based on the content of the NMS plan.

Further, the proposed Rule would directly require each member to (1) collect and submit to the central repository the information required by the Rule, and (2) comply with the clock synchronization requirements of the proposed Rule.<sup>258</sup> In addition, the proposed Rule would require that the NMS plan include a provision that by subscribing to and submitting the plan to the Commission, each exchange and association that is a sponsor to the plan agrees to enforce compliance by its members with the provisions of the plan.<sup>259</sup>

Finally, the proposed Rule would require the NMS plan to include a mechanism to ensure compliance with the requirements of the plan by the members of a national securities exchange or national securities association that is a sponsor of the NMS plan submitted pursuant to this Rule and approved by the Commission.<sup>260</sup> The purpose of this provision is to require the SROs to implement a method to help ensure compliance with the NMS plan and the corresponding SRO rules by their members. Although the Commission is not proposing to mandate the format of the mechanism, the Commission preliminarily believes that it could include the imposition of fines on a member by an SRO of which it is a member in the event the member failed to comply with any provision of the NMS plan or the SRO's rules implementing the NMS plan. Any action taken

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<sup>257</sup> The proposed Rule would require that the NMS plan be filed within 90 days of approval of the proposed Rule. See proposed Rule 613(a)(1).

<sup>258</sup> See proposed Rule 613(g)(2).

<sup>259</sup> See proposed Rule 613(g)(3).

<sup>260</sup> See proposed Rule 613(g)(4).

against the member, including the imposition of the fine by the SRO, would be subject to the requirements of the SRO's other rules.<sup>261</sup>

The Commission requests comment on these provisions regarding members' compliance with the proposed Rule and the NMS plan. Do commenters believe that these provisions would encourage members' compliance with the proposed Rule and the NMS Plan? If so, why? If not, what other provisions would be necessary or appropriate to promote compliance? What mechanisms should be part of a plan to promote compliance by members? Would it appropriate to include violations of the proposed Rule, the NMS plan, or the SRO's rules implementing the NMS plan within existing SRO rules that impose minimum fines for violations of certain SRO rules?<sup>262</sup> Would the exchanges or associations have to amend their rules to implement such a requirement? If so, how would they have to amend their rules? Are there other alternatives that would more effectively help ensure the accuracy and reliability of the information reported to the central repository by members? Would requiring the SROs to file their proposed rule changes to implement the requirements of the NMS plan with respect to the members within 120 days after approval of the proposed Rule provide sufficient time for SROs to draft the proposed rule changes? If not, why not?

#### **I. Operation and Administration of the NMS Plan**

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<sup>261</sup> See Sections 6(b)(6), 6(b)(7), and 6(d)(1) of the Exchange Act, 15 U.S.C. 78f(b)(6), 78f(b)(7), and 78f(d)(1). See also, e.g. FINRA Rule 9217, CHX Article 12, Nasdaq OMX BX Rule 9216 and IM-9216 and NYSE Rule 476A.

<sup>262</sup> See, e.g., FINRA Rule 9217 (providing for the imposition of fines in lieu of commencing a formal disciplinary proceeding for violations of certain rules, including the recording and reporting requirements of the OATS rules) and NYSE Rule 476A (providing for the imposition of fines in lieu of commencing a formal disciplinary proceeding for violations of certain rules, including the OTS rules).

The proposed Rule would require that the NMS plan include a governance structure to ensure fair representation of the plan sponsors.<sup>263</sup> The rule as proposed gives flexibility to the SROs to devise a governance structure as they see fit. The proposed rule would require the NMS plan to include a provision addressing the percentage of votes required by the plan sponsors to effectuate amendments to the plan.<sup>264</sup> For example, the plan sponsors could determine to provide each plan sponsor one vote on matters subject to a vote.<sup>265</sup> Or, if there was a concern that this method would result in “blocs” of plan sponsors under common control exerting control in a one-sponsor, one-vote system, the SROs could choose another alternative to ensure fair representation.

Further, most existing NMS plans require unanimous consent from the plan sponsors to effect an amendment.<sup>266</sup> The Commission recognizes the unanimous consent requirement could be desirable because it helps to ensure that no plan sponsor is forced to comply with requirements with which it is unable to comply, or forced by the other sponsors to pay fees. However, a unanimous consent requirement also could allow one plan sponsor to effectively “veto” a provision

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<sup>263</sup> See proposed Rule 613(b)(1).

<sup>264</sup> See proposed Rule 613(b)(3).

<sup>265</sup> For example, Section 4.3 of the OPRA Plan provides that, except as otherwise provided, each of the members of the Management Committee shall be authorized to cast one vote for each Member that he or she represents on all matters voted upon by the Management Committee, and action of the Management Committee shall be authorized by the affirmative vote of a majority of the total number of votes the members of the Management Committee are authorized to cast, subject to the approval of the Commission whenever such approval is required under applicable provisions of the Exchange Act, and the rules of the Commission adopted thereunder. Action of the Management Committee authorized in accordance with the OPRA Plan shall be without prejudice to the rights of any Member to present contrary views to any regulatory body or in any other appropriate forum.

<sup>266</sup> See, e.g., Securities Exchange Act Release Nos. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (order approving the Options Order Protection and Locked/Crossed Market Plan) and 17638 (March 18, 1981), 22 S.E.C. Docket 484 (March 31, 1981) (order approving the OPRA Plan).

desired by all other plan sponsors for competitive reasons, or permit one sponsor to lag behind in making updates to its systems or rules that would benefit the industry as a whole. The Commission proposes to allow the plan sponsors to determine whether to include in the NMS plan to be filed with the Commission a unanimity requirement for effectuating amendments to the plan, or some other convention.

The Commission also recognizes that the scope or purpose of the proposed NMS plan may differ from existing plans. The Commission requests comment on whether there are lessons from previous experience that suggest that the governance structure of the NMS plan to be filed with the Commission should differ from existing plans. The Commission requests comment on these provisions relating to the governance structure of the plan. Should the Commission require certain governance standards to ensure efficient cooperation, or should the exchanges and association be allowed to create a governance structure of their own choosing? What are the relative merits of unanimity or super majority requirements? What are the relative merits of alternative voting mechanisms and other governance structures available to the plan sponsors? Should the voting mechanism vary by the type of decision or should different decision making bodies have authority over different types of decisions to avoid situations where no decision is made because the sponsors cannot agree? How should the governance and voting mechanisms be set up to avoid inefficient operations or paralysis? Should there be limits on the time frames given to make decisions? Should there be mechanisms to resolve impasses once a decision has taken a certain amount of time? The Commission also requests comment on whether the scope of the plan, including the requirements on broker-dealers members, and the expectation of improved surveillances for investor protection dictate that the governance structure should differ from existing plans. In particular, should the SRO sponsors be required to include in the governance

structure and decision-making authority representatives of members to address member interests and independent representatives chosen specifically to address investor and other public interests?

The proposed Rule also would require that the NMS plan include provisions to govern the administration of the central repository, including the selection of a plan processor. A "plan processor" is defined in Rule 600 of Regulation NMS to mean any SRO or securities information processor acting as an exclusive processor in connection with the development, implementation and/or operation of any facility contemplated by an effective national market system plan.<sup>267</sup>

The Commission expects that the plan sponsors would engage in a thorough analysis and formal competitive bidding process to choose the plan processor. As proposed, the plan sponsors would be required to select a person to act as the plan processor for the central repository no later than two months after the effectiveness of the national market system plan.<sup>268</sup> The Commission preliminarily believes that this time frame would provide the plan sponsors with sufficient time to choose the plan processor, while providing that such entity would be in place with enough time to create and build the central repository to receive data from the SROs within one year after effectiveness of the NMS plan and from the members within two years after such effectiveness.

The Commission requests comment as to whether the proposed Rule should include specific requirements detailing the process for selection of a plan processor. Should the Commission require specific minimum requirements or standards that a plan processor should meet? If so, what requirement or standards would be necessary or appropriate? Should the plan processor be a non-SRO? Would this promote impartiality on the part of the plan processor?

<sup>267</sup> See 17 CFR 242.600(55).

<sup>268</sup> See proposed Rule 613(a)(3)(i).



The Commission also requests comment on the proposed time frame to choose the plan processor. Is it too short? Too long? If so, why? Please be specific in your response.

The proposed Rule also would require that the NMS plan contain a requirement that a Chief Compliance Officer (“CCO”) be appointed to regularly review the operation of the central repository.<sup>269</sup> The CCO would be expected to establish reasonable procedures designed to make sure the operations of the central repository keep pace with technical developments. To the extent upgrades or other changes are necessary to assure the central repository’s effectiveness, the CCO would be responsible for making recommendations for enhancements to the nature of the information collected and the manner in which it is processed.

The Commission requests comment on the necessity for a CCO to oversee the operation of the central repository. If commenters support the proposal to require a CCO, should the proposed Rule include a requirement that the CCO be independent from the plan sponsors and their members? That is, should the CCO be required to not have any actual or potential conflicts of interest with respect to the plan sponsors and their members (e.g. such as prior or future employment with a plan sponsor or member, or a material business relationship with a plan sponsor or member)? What are the risks of allowing a CCO who is affiliated or associated with a plan sponsor or its members? What types of conflicts of interest should be avoided? Are there any specific qualifications that a CCO should possess? Should there be a specific process in place for appointing a CCO or for removing a CCO for failure to perform his or her assigned duties? Should there be a limit to the number of years a CCO may serve as such?

The plan sponsors also would be required to include in the NMS plan a provision addressing the requirements for the admission of new sponsors to the plan and the withdrawal of

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<sup>269</sup> See proposed Rule 613(b)(5).

sponsors from the plan.<sup>270</sup> Proposed Rule 613(b)(4) also would require that the sponsors develop a process for allocating among the plan sponsors the costs associated with implementing and operating the central repository, including a provision addressing the manner in which such costs would be allocated to sponsors who join the plan after it was approved. Various NMS plans have developed different ways to ensure that a fair cost or "new participant fee" is assessed upon new plan sponsors.<sup>271</sup> For example, when determining a new participation fee, the OPRA Plan requires that the following factors be considered: (1) the portion of costs previously paid by OPRA for the development, expansion and maintenance of OPRA's facilities which, under generally accepted accounting principles, would have been treated as capital expenditures and would have been amortized over the five years preceding the admission of the new member; (2) an assessment of costs incurred and to be incurred by OPRA for modifying the OPRA System or any part thereof to accommodate the new member, which are not otherwise required to be paid or reimbursed by the new Member; and (3) previous fees paid by other new members. The plan sponsors could choose to include in the NMS plan to be filed a similar provision or develop a new method for determining the cost to join the plan that would better suit the NMS plan proposed to be required by this Rule.

The Commission requests comment on whether the rule or plan should specify a method for allocating costs among the plan sponsors. The Commission also requests comment as to what provisions the exchanges and FINRA should include in the NMS plan relating to the admission of new plan sponsors and the withdrawal of existing plan sponsors. Should the Commission specify the process for the admission of new plan sponsors? What are the concerns, if any, that should be taken into account when providing for the admission of new plan sponsors?

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<sup>270</sup> See proposed Rule 613(b)(2).

<sup>271</sup> See e.g. Section 7.1 of OPRA Plan.

The Commission requests comment on all aspects of the proposed Rule relating to governance and administration of the NMS plan.

**J. Proposed Implementation Schedule**

While the Commission preliminarily believes a comprehensive consolidated audit trail would be useful as soon as possible, the Commission also believes that it would be prudent to implement the Rule at a measured pace to ensure that all market participants are fully able to meet the requirements of the proposed Rule. Therefore, the proposed Rule would provide that the proposed data collection and submission requirements would first apply to national securities exchanges and national securities associations, but not to their individual members. As part of operating their businesses, the national securities exchanges and national securities associations are accustomed to handling large volumes of data and many already have in place electronic trading, routing and reporting systems.<sup>272</sup> Further, under the proposal the exchanges would not be responsible for providing to the central repository, for each order, information relating to the customer. The Commission therefore preliminarily believes these systems could more readily and quickly be modified than the members' systems to comply with the requirements of the proposed Rule.

Specifically, proposed Rule 613(a)(3)(iii) would require the exchanges and associations to provide to the central repository the data to be required by the Rule within one year after effectiveness of the NMS plan. Members of the exchanges and associations would be required to begin providing to the central repository the data required by the proposed Rule two years after effectiveness of the NMS plan, which would be one year following the implementation deadline

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<sup>272</sup> For example, as part of COATS compliance, the options exchanges are required to have in place systems to electronically capture all order, transaction, and quotation information on the exchange.

for the national securities exchanges and national securities associations.<sup>273</sup> This phased approach is designed to allow members additional time to implement systems changes necessary to begin providing the information to the central repository and to develop procedures designed to capture customer and order information that they may not have previously been required to collect to comply with other Commission and SRO rules.

The Commission requests comment on the proposed implementation time periods. Are these time periods practical or feasible? Should they be shorter? Longer? Please provide detailed reasons in your response. As proposed, the national securities exchanges and national securities associations would be required to submit data to the central repository for one year before their members are required to submit data. Is requiring the exchanges and FINRA to provide data before requiring their members to do so a feasible way to phase in compliance with the proposed rule? How would this phased-in approach affect the quality of the data and the number of available data items in the audit trail? Are there alternative ways to phase in implementation that would be more practical? For instance, should the Commission consider requiring all exchanges and FINRA and their respective members to begin reporting a subset of the data initially, and phase in the collection of additional data over time? Should the Commission require all exchanges, FINRA, and their members to implement the proposed requirements first for NMS stocks, then for listed options? Or vice versa? How should the Commission take into consideration any concern commenters might have that market participants might shift manipulative or other illegal trading activity to products or markets not covered by the proposed Rule in its analysis of whether, or how, to phase in compliance with the proposed Rule across products classes (meaning, NMS stock and listed options)? If so, how?

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<sup>273</sup> See proposed Rule 613(a)(3)(v).

Should ATSS,<sup>274</sup> including so-called dark pools,<sup>275</sup> be required to implement the proposed requirements before broker-dealers that are not registered as ATSS? Would ATSS be able to more quickly comply with the proposed recording and reporting requirements, since they generally are highly automated and their business may be more narrowly focused than, for example, broker-dealers that engage in a customer, proprietary, and/or market making business? Are there any cost savings associated with a phased approach to implementation? Would additional unnecessary costs be incurred by implementing the plan in a phased-in approach? Please provide data to support your views.

#### IV. Request for Comments

We request and encourage any interested person to comment generally on the proposed Rule. In addition to the specific requests for comment throughout the release, the Commission requests general comment on all aspects of proposed Rule 613 of Regulation NMS. The Commission encourages commenters to provide information regarding the advantages and disadvantages of each aspect of the proposed Rule. The Commission invites commenters to provide views and data as to the costs and benefits associated with the proposed Rule. The Commission also seeks comment regarding other matters that may have an effect on the proposed Rule. We request comment from the point of view of national securities exchanges, national securities associations, members, investors, and other market participants. With regard

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<sup>274</sup> See supra note 181.

<sup>275</sup> Dark pools are ATSS that do not provide their best-priced orders for inclusion in the consolidated quotation data. In general, dark pools offer trading services to institutional investors and others that seek to execute large trading interest in a manner that will minimize the movement of prices against the trading interest and thereby reduce trading costs. Dark pools fall within the statutory definition of an exchange, but are exempted if they comply with Regulation ATS. See Concept Release on Equity Market Structure, supra note 19, at 3599, and supra note 181.

to any comments, we note that such comments are of great assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments.

## V. Paperwork Reduction Act

Certain provisions of the proposal contain "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995 ("PRA")<sup>276</sup> and the Commission has submitted them to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The title of the new collection of information is "Creation of a Consolidated Audit Trail Pursuant to Section 11A of the Securities Exchange Act of 1934 and Rules Thereunder."

### A. Summary of Collection of Information under Proposed Rule 613

#### 1. Creation and Filing of an NMS Plan

As detailed above, the proposed Rule would require each national securities exchange and national securities association to jointly file with the Commission, on or before 90 days from approval of the proposed Rule, an NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail and central repository for the collection of information for NMS securities.<sup>277</sup> The NMS plan would be required to require each exchange or association and its respective members to provide certain data to the central repository in compliance with proposed Rule 613.<sup>278</sup> The NMS plan also would need to include certain specified provisions

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<sup>276</sup> 44 U.S.C. 3501 et. seq.

<sup>277</sup> See proposed Rule 613(a)(1) and supra Section III.

<sup>278</sup> See proposed Rule 613(c) and supra Section III.D.

related to administration and operation of the plan,<sup>279</sup> and the operation of the central repository.<sup>280</sup> Further, the NMS plan would be required to include certain provisions related to compliance by the exchanges and associations and their members with the requirement of the proposed Rule and the NMS plan.<sup>281</sup>

Each national securities exchange and national securities association would be required to be a sponsor of the NMS plan.<sup>282</sup> The Commission preliminarily believes that requiring the proposed NMS plan would impose a paperwork burden on national securities exchanges and national securities associations associated with preparing and filing the joint NMS plan.

## 2. Report

<sup>279</sup> For example, the NMS plan would be required to include provisions: (1) to ensure fair representation of the plan sponsors; (2) for administration of the central repository; (3) addressing the requirements for admission of new plan sponsors and withdrawal of existing plan sponsors; (4) addressing the percentage of votes required by the plan sponsors to effectuate amendments to the plan; (5) addressing the manner in which the costs of operating the central repository would be allocated among the national securities exchanges and national securities associations that are sponsors of the plan, including a provision addressing the manner in which costs would be allocated to new sponsors to the plan. See proposed Rule 613(b).

<sup>280</sup> For example, the NMS plan would be required to include a provision requiring the creation and maintenance by the central repository of a method of access to the data, including search and reporting functions. See proposed Rule 613(e)(3). Additionally, the NMS plan would be required to include policies and procedures, including standards, to be used by the plan processor to: (1) ensure the security and confidentiality of all information submitted to, and maintained by, the central repository; (2) ensure the timeliness, accuracy, and completeness of the data provided to the central repository; (3) require the rejection of data that does not meet validation parameters and the retransmission of corrected data; and (4) ensure the accuracy of the consolidation by the plan processor of the data provided to the central repository. See proposed Rule 613(e)(4).

<sup>281</sup> The NMS plan would be required to include: (1) a provision that by subscribing to and submitting the plan to the Commission, each national securities exchange and national securities association that is a sponsor to the plan agrees to enforce compliance by its members with the provisions of the plan; and (2) a mechanism to ensure compliance by the sponsors of the plan with the requirements of the plan. See proposed Rule 613(g)(3) and (h)(3).

<sup>282</sup> See proposed Rule 613(a)(5).

Rule 613(i) also would require the national securities exchanges and national securities associations to jointly provide to the Commission a document outlining how such national securities exchanges and national securities associations would propose to incorporate into the consolidated audit trail information for: (1) equity securities that are not NMS securities; (2) debt securities; and (3) primary market transactions in NMS stocks, equity securities that are not NMS securities and debt securities.<sup>283</sup> This report would be required to specify in detail the data that would be collected and reported by each market participant, an implementation timeline, and a cost estimate. The Commission preliminarily believes that requiring the proposed report would impose a paperwork burden on national securities exchanges and national securities associations associated with preparing and submitting the report to the Commission.

### **3. Rule Filings by National Securities Exchanges and National Securities Associations**

Each national securities exchange and national securities association would be required to file with the Commission, pursuant to Section 19(b)(2) of the Exchange Act and Rule 19b-4 thereunder,<sup>284</sup> a proposed rule change to require its members to comply with the requirements of the proposed Rule and the NMS plan submitted pursuant to the proposed Rule and approved by the Commission of which the national securities exchange or national securities association is a sponsor.<sup>285</sup> The burden of filing such proposed rule change would already be included under the collection of information requirements contained in Rule 19b-4 under the Exchange Act.<sup>286</sup>

<sup>283</sup> See proposed Rule 613(i).

<sup>284</sup> 15 U.S.C. 78s(b)(2) and 17 CFR 240.19b-4.

<sup>285</sup> See proposed Rule 613(g)(1).

<sup>286</sup> See Securities Exchange Act Release No. 50486 (October 5, 2004), 69 FR 60287, 60293 (October 8, 2004) (File No. S7-18-04) (describing the collection of information requirements contained in Rule 19b-4 under the Exchange Act). The Commission has submitted revisions to the current collection of information titled "Rule 19b-4 Filings



#### 4. Collection and Retention of NBBO and Last Sale Data

The central repository would be required to collect and retain on a current and continuing basis the national best bid and national best offer for each NMS security, transaction reports reported pursuant to a transaction reporting plan filed with the Commission pursuant to, and meeting the requirements of, Rule 601 of Regulation NMS, and last sale reports reported pursuant to the OPRA Plan.<sup>287</sup> The central repository would be required to retain this information for a period of not less than five years.<sup>288</sup>

#### 5. Data Collection and Reporting

The proposed Rule would require each national securities exchange, national securities association, and any member of such national securities exchange or national securities association to collect and electronically provide to the central repository details for each order and reportable event documenting the life of an order through the process of routing, modification, cancellation, and execution (in whole or in part).<sup>289</sup> The proposed Rule would require the collection and reporting to the central repository of some information that national securities exchanges, national securities associations, and their members already are required to collect, and under certain circumstances, report to a third party, in compliance with existing Commission<sup>290</sup> and SRO requirements.<sup>291</sup> The proposed Rule would, however, require

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with Respect to Proposed Rule Changes by Self-Regulatory Organizations” (OMB Control No. 3235-0045). According to the last submitted revision concluded as of August 5, 2008, the current collection of information estimates 1,279 total annual Rule 19b-4 filings with respect to proposed rule changes by self-regulatory organizations.

<sup>287</sup> See proposed Rule 613(e)(5); 17 CFR 242.601.

<sup>288</sup> See proposed Rule 613(e)(6).

<sup>289</sup> See proposed Rule 613(c)(1) and *supra* Section III.D.

<sup>290</sup> For example, Rule 17a-3 requires broker-dealers to maintain the following information that would be captured by the proposed Rule: customer name and address; time an order was received; and price of execution. 17 CFR 240.17a-3. Also, Rule 17a-25 requires

exchanges, associations, and their members to report to the central repository information not required to be currently collected and reported pursuant to existing SRO audit trail rules.

For example, although members of national securities exchanges and national securities associations already should know the identity of their customers, and in some instances may be required to provide that information to the Commission or SRO staff upon request,<sup>292</sup> the requirement to electronically capture and report detailed information sufficient to identify the customer to the central repository, in real time, would be new. Further, although some existing audit trail requirements include a unique order identifier,<sup>293</sup> the proposed Rule's requirement that the unique order identifier remain with the order throughout its entire life, across markets and market participants, would go beyond the current requirements. In addition, although such members currently have unique market participant identifiers ("MPIDs"), such MPIDs may

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brokers to maintain the following information with respect to customer orders: date on which the transaction was executed; account number; identifying symbol assigned to the security; transaction price; the number of shares or option contracts traded and whether such transaction was a purchase, sale, or short sale, and if an option transaction, whether such was a call or put option; the clearing house number of such broker or dealer and the clearing house numbers of the brokers or dealers on the opposite side of the transaction; prime broker identifier; the customer's name and address; the customer's tax identification number; and other related account information. 17 CFR 240.17a-25. This information would be captured by the proposed Rule. See also Section 17(a) of the Exchange Act, 15 U.S.C. 78q(a), and Rules 17a-1 and 17a-4 under the Exchange Act, 17 CFR 240.17a-1 and 17 CFR 240.17a-4.

<sup>291</sup> The audit trail rules of several of the national securities exchanges and FINRA require the following information be recorded: Date order was originated or received by a member, security or option symbol, clearing member organization, order identifier, market participant symbol, number of shares executed, designation of order as short sale, limit order, market order, stop order or stop limit order, account type or number, date and time of execution, and execution price and size. See BOX Ch. V, Section 4; BX Rule 6955; FINRA Rule 7440; Nasdaq Options Market Chapter IX, Section 4; Nasdaq Rule 6955; NYSE Rule 132B; and NYSE Amex Equities Rule 132B. This information would be captured pursuant to the proposed Rule.

<sup>292</sup> See supra Section I.A. (discussing Rule 17a-25 and the EBS system).

<sup>293</sup> See supra Section I.C. (discussing the requirements of FINRA's OATS).

differ across markets, whereas the proposed Rule would require that each member have a unique identifier that is the same across all markets. The proposed requirements to report whether an order opens or closes a position for NMS stocks, and to report borrow information, also are not required to be marked on orders by current SRO or Commission rules. Further, much of the information that would be required for the first time to be reported to the central repository would be reported in real time, as the event is occurring.

## **6. Central Repository**

The proposed Rule would require that the central repository be responsible for the receipt, consolidation, and retention of all data submitted to the central repository by the national securities exchanges, national securities associations, and their members.<sup>294</sup> The proposed Rule also would require that (1) the central repository retain the information collected pursuant to subparagraph (c)(7) and (e)(5) of the proposed Rule in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years, and (2) the information be available immediately, or if immediate availability cannot reasonably and practically be achieved, that any search query begin operating on the data not later than one hour after the search query is made.<sup>295</sup> The Commission notes that a plan processor would be responsible for operating the central repository in compliance with the proposed Rule and the NMS plan.

### **B. Proposed Use of Information**

#### **1. Creation and Filing of NMS Plan**

<sup>294</sup> See proposed Rule 613(e)(1). The Commission notes that a plan processor would be responsible for operating the central repository in compliance with the proposed Rule and the NMS plan.

<sup>295</sup> See proposed Rule 613(e)(6).

As discussed in detail above, the NMS plan would govern the creation, implementation, and maintenance of a consolidated audit trail for NMS securities, which would aid the Commission and national securities exchanges and national securities associations in effectively and efficiently carrying out their regulatory responsibilities. The information that would be collected pursuant to the NMS plan would allow the SROs to more efficiently monitor trading activity in the securities markets, and would facilitate the Commission and the national securities exchanges and national securities associations' trading reconstruction efforts as well as enhance their monitoring, enforcement, and regulatory activities.

## 2. Report

As the Commission states above in Section III.A., it ultimately intends for the proposed consolidated audit trail, if adopted, to be expanded to cover other securities, including equity securities that are not NMS securities, corporate bonds and other debt instruments; credit default swaps and other security-based swaps; and any other products that may come under the Commission's jurisdiction in the future. Further, the Commission preliminarily believes that it would be beneficial to expand the consolidated audit trail to include information on primary market transactions in NMS stocks and other equity securities that are not NMS stocks, as well as primary market transactions in debt securities. The Commission preliminarily believes that a timely expansion of the scope of the consolidated audit trail beyond NMS securities would be beneficial as illegal trading strategies that the consolidated audit trail would be designed to help detect and deter, such as insider trading, may involve trading in multiple related products other than NMS securities across multiple markets.

To help ensure that such an expansion would occur in a reasonable time and that the systems and technology that would be used to implement the Rule as proposed are designed to be

easily scalable, proposed Rule 613(i) would require that the NMS plan contain a provision requiring each national securities exchange and national securities association that is a sponsor of the plan to jointly provide to the Commission within two months after effectiveness of the NMS plan a document outlining how the sponsors would incorporate into the consolidated audit trail information with respect to: (1) equity securities that are not NMS securities; (2) debt securities; and (3) primary market transactions in NMS stocks, equity securities that are not NMS securities, and debt securities. The sponsors specifically would be required to address, among other things, details for each order and reportable event that they would recommend requiring to be provided; which market participants would be required to provide the data; an implementation timeline; and a cost estimate. The Commission would be able to use the information contained in the report in its consideration and analysis of whether to expand the consolidated audit trail.

### 3. Collection and Retention of NBBO and Last Sale Data

As discussed above, the requirement that the central repository collect and retain the NBBO and transaction data in an electronic format compatible with the order and event information collected pursuant to the proposed Rule is intended to allow SRO and Commission staff to easily search across order, NBBO, and transaction data bases. The Commission preliminarily believes that having the NBBO information in an electronic format compatible with the order audit trail information would be useful for SROs to enforce compliance with federal securities laws, rules and regulations.<sup>296</sup> The Commission also preliminarily believes that

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<sup>296</sup> The NBBO is used by SROs and the Commission to evaluate members for compliance with numerous regulatory requirements, such as the duty of best execution or Rule 611 of Regulation NMS. See Rule 611 of Regulation NMS, 17 CFR 242.611. See also ISE Rule 1901, NYSE Arca 6.94, and Phlx Rule 1084. An SRO would be able to compare order execution information to the NBBO information on a more timely basis because the order and execution information would be available on a real time basis and all of the information would be available in a compatible format in the same database. The SROs

requiring the central repository to collect and retain in its database the transaction information in a format compatible with the order execution information would aid the SROs in being able to monitor for certain market manipulations.<sup>297</sup>

#### 4. Data Collection and Reporting

As discussed above, the Commission preliminarily believes that the data collection and reporting requirements of the proposed Rule would enhance the ability of SRO staff to effectively monitor and surveil the securities markets and thus detect and investigate potentially illegal activity in a more timely fashion, whether on one market or across markets. Further, the Commission preliminarily believes that the ability to access such data would improve the ability of SRO staff to conduct timely and accurate trading analysis for market reconstructions and complex enforcement inquiries or investigations, as well as inspections and examinations. Further, the Commission preliminarily believes that the ability to access such data would aid the Commission staff in its regulatory and market analysis efforts.

#### 5. Central Repository

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also may enjoy economies of scale by adopting standard cross-market surveillance parameters for certain types of violations.

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See *supra* Section III.D.1.v. As discussed above, the proposed Rule would require that each report of the execution (in whole or in part) of an order sent to the central repository include a notation as to whether the execution was reported to the consolidated tape pursuant to an effective transaction reporting plan or the OPRA Plan. This requirement should allow regulators to more efficiently evaluate certain trading activity. For example, trading patterns of reported and unreported trades may cause the staff of an SRO or the Commission to make further inquiry into the nature of the trading to ensure that the public was receiving accurate and timely information regarding executions and that market participants were continuing to comply with the trade reporting obligations under SRO rules. Similarly, patterns in the reported and unreported transactions could be indicia of market abuse, including failure to obtain best execution for customer orders or possible market manipulation. Being able to more efficiently compare the consolidated order execution data with the trades reported to the consolidated tape could thus be an important component of overall surveillance activity.

The central repository would be required to receive and retain the data required to be submitted by the national securities exchanges, national securities associations, and their members pursuant to the proposed Rule. SROs and Commission staff would then have access to the data for regulatory purposes, as discussed above.

**C. Respondents**

**1. National Securities Exchanges and National Securities Associations**

Proposed Rule 613 would apply to all of the fourteen national securities exchanges and to one national securities association (FINRA) currently registered with the Commission.

**2. Members of National Securities Exchanges and National Securities Associations**

Proposed Rule 613 would apply to the approximately 5,178 broker-dealers that are currently registered with the Commission and are members of the national securities exchanges or FINRA.<sup>298</sup>

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

**1. Burden on National Securities Exchanges and National Securities Associations**

**a. Creation and Filing of NMS Plan**

Proposed Rule 613 would require the national securities exchanges and FINRA to jointly file with the Commission a joint NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail and a central repository. The Commission estimates that it would take each national securities exchange and national securities association approximately 840 burden hours of internal legal, compliance, information technology, and

<sup>298</sup>

This is the number of broker-dealers filing FOCUS Reports at year-end 2008. FOCUS Reports are required to be filed by all registered broker-dealers, with a few exceptions. Excluded from this number were recently established broker-dealers that had yet to become active, or broker-dealers no longer doing business that had yet to deregister.

business operations time to develop and file the NMS plan, including the required provisions regarding governance, administration, and operation of the plan.<sup>299</sup>

The Commission preliminarily expects that national securities exchange and national securities association respondents may incur one-time external costs for outsourced legal services to develop and draft the NMS plan. While the Commission recognizes that the amount of legal outsourcing used may vary from SRO to SRO, the staff estimates that on average, each national securities exchange and national securities association would outsource 50 hours of legal time to develop and draft the NMS plan, for a capital cost of approximately \$20,000 for each national securities exchange and national securities association resulting from outsourced legal work.<sup>300</sup> Therefore, the Commission preliminarily estimates that the average one-time initial burden of developing and filing the NMS plan would be 840 burden hours plus \$20,000 external costs for outsourced legal counsel per SRO, for an aggregate estimated burden of 12,600 hours plus \$300,000 external costs.

Once the national securities exchanges and national securities associations have established the NMS plan, the Commission estimates that, on average, each national securities exchange and national securities association would incur 192 burden hours annually to ensure

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<sup>299</sup> The Commission derived the total estimated burdens from the following estimates, which are based on the Commission's understanding of, and burden estimates for, existing NMS plans: (Attorney at 400 hours) + (Compliance Manager at 100 hours) + (Programmer Analyst at 220 hours) + (Business Analyst at 120 hours). The Commission preliminarily believes that the cost of developing and filing the NMS plan pursuant to the proposed Rule would be comparable to the cost to create other existing NMS plans, recognizing that the proposed Rule may include more detail as to what must be incorporated and addressed in the NMS plan implementing the proposed Rule.

<sup>300</sup> Based on industry sources, the Commission estimates that the hourly rate for outsourced legal services in the securities industry is \$400 per hour.



that the NMS plan is up to date and remains in compliance with the proposed Rule,<sup>301</sup> for an aggregate estimated burden of 2,880 hours.

**b. Report**

The Commission estimates that it would take each national securities exchange or national securities association approximately 420 burden hours of internal legal, compliance, business operations and information technology staff time to create the report required by the proposed Rule.<sup>302</sup> The Commission also expects that each national securities exchange and national securities association respondent may incur one-time external costs for outsourced legal services helping to prepare the report. Commission estimates that on average, each national securities exchange and national securities association would outsource 25 hours of legal time to create the report, for an aggregate one-time capital cost of approximately \$10,000.<sup>303</sup> Therefore, the Commission preliminarily estimates that the one-time initial burden of drafting the report required by the proposed Rule would be 420 burden hours plus \$10,000 external costs for outsourced legal counsel per SRO, for an aggregate estimated burden of 6,300 hours and \$150,000 external costs.

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<sup>301</sup> The Commission derived the total estimated burdens from the following estimates, which are based on prior Commission experience with burden estimates: (Attorney at 64 hours) + (Compliance Manager at 64 hours) + (Programmer Analyst at 64 hours) = 192 burden hours.

<sup>302</sup> The Commission derived the total estimated burden from the following estimates, which assumes preparation of the report would impose approximately half of the approximate burden of preparing the Plan, reflects half of the approximate burden of drafting and filing the NMS plan, and the Commission's preliminary view that the cost of preparing the report would not be as extensive as the drafting and filing of the NMS plan: (Attorney at 200 hours) + (Compliance Manager at 50 hours) + (Programmer Analyst at 110 hours) + (Business Analyst at 60 hours) = 420 burden hours per SRO.

<sup>303</sup> The Commission derived the total estimated burden for outsourced legal counsel based on the assumption that the report required by the proposed Rule would require approximately half the effort of drafting and filing the proposed NMS plan.

**c. Data Collection and Reporting**

The proposed Rule would require the collection and reporting on a real time basis of some information that national securities exchanges and national securities associations already collect to operate their business, and are required to maintain in compliance with Section 17(a) of the Exchange Act and Rule 17a-1 thereunder.<sup>304</sup> For instance, the Commission believes that exchanges keep records pursuant to Section 17(a) of the Exchange Act and Rule 17a-1 thereunder in electronic form, of the receipt of all orders entered into their systems, as well as records of the routing, modification, cancellation, and execution of those orders. However, the proposed Rule would require each SRO to collect and report additional and more detailed information, and to report the information to the central repository in real time in a specified uniform format. The Commission anticipates that exchanges may need to enhance or replace their current systems to be able to comply with the proposed information collection and reporting requirements of the proposed Rule.

The Commission recognizes that the extent to which a particular SRO would need to make systems changes would differ depending upon the SRO's current market structure and existing systems. However, the Commission preliminarily estimates that, on average, the initial one-time burden per national securities exchange and national securities association for development and implementation of the systems needed to capture the required information and transmit it to the central repository in a specified format in compliance with the proposed Rule to be 2,200 hours.<sup>305</sup> Further, the Commission estimates that, on average, each exchange and

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<sup>304</sup> 15 U.S.C. 78q(a); 17 CFR 240.17a-1.

<sup>305</sup> The Commission derived the total estimated burdens from the following estimates, which reflect the Commission's experience with, and burden estimates for, SRO systems changes, and discussions with market participants: (Attorney at 100 hours) +

association would incur approximately 40 hours of outsourced legal counsel legal time for the development and implementation of systems needed to capture the required information and transmit it to the central repository, and a one time software and hardware cost of \$4,542,940 per SRO to develop and implement the necessary systems. Therefore, the Commission preliminarily estimates that the average one-time initial burden per national securities exchange and national securities association for development and implementation of the systems needed to capture the required information and transmit it to the central repository in a specified format in compliance with the proposed Rule would be 2,200 burden hours plus \$16,000 costs for outsourced legal counsel and \$4,542,940 for hardware and software costs,<sup>306</sup> for an aggregate estimated burden of 33,000 hours and \$68,384,100 external and systems costs.

Once a national securities exchange or national securities association has established the appropriate systems required for collection and transmission of the required information to the central repository in a specified format, the Commission preliminarily believes that it would be necessary for each national securities exchange or national securities association to undertake efforts to ensure that their system technology is up to date and remains in compliance with the proposed Rule, which could include personnel time to monitor each SRO's reporting of the required data and the maintenance of the systems to report the required data; activity related to adding extra systems capacity to accommodate new order types that would need to be reported to

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(Compliance Manager at 80 hours) + (Programmer Analyst at 1,960 hours) + (Business Analyst at 60 hours) = 2,200 burden hours per SRO.

<sup>306</sup> These estimates are based on the Commission's previous experience with, and cost estimates for, SRO systems changes, and discussions with market participants. See Securities Exchange Act Release No. 50870 (December 16, 2004), 69 FR 77424, (December 27, 2004) ("Regulation NMS Reproposing Release") at 77480 (discussing costs to implement Rule 611 of Regulation NMS). Although the Commission recognizes that the substance of Rule 611 of Regulation NMS is not the same as the proposed Rule, the Commission preliminarily believes that the scope of the systems changes would be comparable.

the central repository; or implementing changes to trading systems which might result in additional reports to the central repository. The Commission preliminarily estimates that, on average, it would take a national securities exchange or national securities association approximately 4,975 hours per year to ensure that the system technology is up to date and remains in compliance with the proposed Rule.<sup>307</sup> The Commission also estimates that it would cost, on average, approximately \$1.25 million per year per SRO to continue to comply with the proposed requirements to provide information to the central repository, including costs to maintain the systems connectivity to the central repository and purchase any necessary hardware, software, and other materials.<sup>308</sup> Therefore, the Commission preliminarily estimates that the average ongoing annual burden per SRO would be approximately 4,975 hours plus \$1.25 million external costs to maintain the systems necessary to collect and transmit information to the central repository, for an aggregate estimated annual burden of 74,625 hours and \$18,750,000 external systems costs.

**d. Central Repository**

The proposed Rule would require national securities exchanges and national securities associations to jointly establish a central repository tasked with the receipt, consolidation, and retention of the reported order and execution information. The central repository thus would need its own system(s) to receive, consolidate, and retain the electronic data received from the

<sup>307</sup> The Commission derived the total estimated burdens from the following estimates, which reflect the Commission's preliminary view that annual ongoing costs would be approximately half the costs of developing and implementing the systems to capture the required information and transmit it to the central repository, and discussions with market participants: (Attorney at 1,500 hours) + (Compliance Analyst at 1,600 hours) + (Programmer Analyst at 1,375 hours) + (Business Analyst at 500 hours) = 4,975 burden hours per SRO.

<sup>308</sup> This estimate includes an estimated cost of approximately \$10,000 per month to maintain systems connectivity to the central repository, including back-up connectivity. This estimate is based on discussions with a market participant.

SROs and their members. The system would be required to be accessible by the sponsors and the Commission for regulatory purposes, with validation parameters allowing the central repository to automatically check the accuracy and completeness of the data submitted, and reject data not conforming to these parameters. It is anticipated that the burdens of development and operation of the central repository would be shared among the plan sponsors.

The Commission staff preliminarily estimates that there would be an average initial one-time burden of 17,500 hours per plan sponsor for development and implementation of the systems needed to capture the required information in compliance with the proposed Rule.<sup>309</sup>

Further, the Commission estimates that each exchange and association would incur software and hardware costs of approximately \$4 million per plan sponsor related to systems development.

Therefore, the Commission preliminarily estimates a one-time initial burden of 17,500 hours per plan sponsor, plus software and hardware costs of approximately \$4 million related to systems development,<sup>310</sup> for an aggregate estimated burden of 262,500 hours and \$60 million in external systems costs.

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<sup>309</sup> The Commission derived the total estimated burdens based on the following estimates, which are based on information provided to the Commission regarding the development of reporting systems for the collection, consolidation, and dissemination of quotation and last sale data and discussions with market participants: (Attorney at 3,000 hours) + (Compliance Manager at 4,000 hours) + (Programmer Analyst at 7,500 hours) + (Business Analyst at 3,000 hours) = 17,500 per SRO. This figure excludes the number of burden hours required to create and file the NMS plan.

<sup>310</sup> This cost estimate includes the estimated costs that each exchange and association would incur for software and hardware costs related to systems development. This cost estimate also would encompass (1) costs related to engaging in an analysis and formal bidding process to choose the plan processor, and (2) any search undertaken to hire a CCO. See proposed Rule 613(a)(3)(i) (the plan sponsors would be required to select a person to act as a plan processor for the central repository no later than two months after the effectiveness of the NMS plan) and 613(b)(5) (the plan sponsors would be required to appoint a CCO to regularly review the operation of the central repository to assure its continued effectiveness in light of market and technological developments, and make any

Once the plan sponsors have established the systems necessary for the central repository to receive, consolidate, and retain the required information, the Commission estimates that the burden per plan sponsor to ensure that the system technology and functionality is up to date and remains in compliance with the proposed Rule would be 192 hours per year, for an estimated aggregate burden per year of 2,880 hours.<sup>311</sup> The estimated burden would include actions taken to regularly review the operation of the central repository to assure its continued effectiveness and to determine the need for enhancements to accommodate the information required to be collected, or new information collected, and the manner in which the data is processed, as well as periodic assessments of the adequacy of the system technology and functionality of the central repository.

After the central repository systems have been developed and implemented, there would be ongoing costs for operating the central repository, including the cost of paying the CCO; the cost of systems and connectivity upgrades or changes necessary to receive, consolidate, and store the reported order and execution information from SROs and their members; the cost, including storage costs, of collecting and maintaining the NBBO and transaction data in a format compatible with the order and event information collected pursuant to the proposed Rule; the cost of monitoring the required validation parameters, which would allow the central repository to automatically check the accuracy and completeness of the data submitted and reject data not conforming to these parameters consistent with the requirements of the proposed Rule; and the cost of compensating the plan processor. The Commission preliminarily assumes that the plan

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appropriate recommendations for enhancements to the nature of the information collected and the manner in which the information is processed).

<sup>311</sup> The Commission derived the total estimated burdens from the following estimates, which are based on prior Commission experience with burden estimates: (Attorney at 16 hours) + (Compliance Manager at 16 hours) + (Programmer Analyst at 16 hours) = 48 burden hours per quarter, or 192 burden hours per year.

processor would be responsible for the ongoing operations of the central repository. The Commission estimates that these costs would be approximately \$100 million in external costs to the plan processor for operation of the central repository per year, or approximately \$6,666,666 per plan sponsor per year.<sup>312</sup>

**e. Collection and retention of the NBBO and transaction reports**

The proposed Rule would require that the central repository collect and retain on a current and continuous basis the NBBO for each NMS security, transaction reports reported pursuant to an effective transaction reporting plan, and last sale reports reported pursuant to the OPRA Plan. The central repository would be required to maintain this NBBO and transaction data in a format compatible with the order and event information collected pursuant to the proposed Rule.<sup>313</sup> Further, the central repository would be required to retain the information collected pursuant to paragraphs (c)(7) and (e)(5) of the proposed Rule in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years. The information would be required to be available immediately, or if immediate availability could not reasonably and practically be achieved, any search query would be required to begin operating on the data not later than one hour after the search query is made.<sup>314</sup>

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<sup>312</sup> The Commission derived the total estimated burdens based on discussions with market participants. The estimated annual cost includes an annual salary for a CCO of \$703,800. This figure is based on a \$391 per-hour figure for a Chief Compliance Officer from SIFMA'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.

<sup>313</sup> See proposed Rule 613(e)(5).

<sup>314</sup> See proposed Rule 613(e)(6).

The Commission preliminarily has included in the burden estimates to the plan sponsors of developing and implementing the systems necessary to capture the order audit trail information (see supra Section V.D.1.d) the: (1) initial one-time hour burden per plan sponsor for development and implementation of the systems at the central repository necessary to receive and retain this NBBO and last sale information; (2) associated software and hardware costs; and (3) ongoing costs of receiving and retaining the NBBO and last sale information.<sup>315</sup>

The Commission estimates that the ongoing external costs to receive the NBBO and last sale data from the SIPs would be approximately \$1,370 per year.<sup>316</sup>

## 2. Members

The Commission preliminarily believes that the proposed Rule would require the collection and reporting in real time of much of the information that registered broker-dealers already maintain in compliance with existing regulations.<sup>317</sup> For example, Section 17 of the Exchange Act and Rule 17a-3 thereunder mandate that broker-dealers keep certain records of orders handled during the course of business.<sup>318</sup> Certain information also is required to be

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<sup>315</sup> See supra Section V.D.1.d.

<sup>316</sup> The Commission derived this estimate based on the average current cost of obtaining consolidated quotation and transaction information from existing quotation and transaction reporting plans.

<sup>317</sup> See Section 17(a) of the Exchange Act, 14 U.S.C. 78q(a), and Rules 17a-3, 17a-4, and 17a-25 under the Exchange Act, 17 CFR 240.17a-3, 17 CFR 240.17a-4, and 17 CFR 240.17a-25; see also, e.g., BATS Rule 20.7; BOX Chapter V, Section 4; CBOE Chapter VI, Rule 6.24; CHX Article 11, Rule 3; FINRA Rule 7440; Nasdaq Options Market Chapter IX, Section 4; NYSE Rule 132B; and NYSE Amex Equities Rule 132B.

<sup>318</sup> 15 U.S.C. 78q et seq.; 17 CFR 240.17a-3. Generally, broker-dealers must keep a memorandum of each brokerage order, including the following information: the terms and conditions of an order or instructions; the account for which an order was entered; time of order entry and receipt and, to the extent feasible, time of execution; any modifications or cancellations (and, to the extent feasible, time of cancellation); execution price; and the identity of each associated person, if any, responsible for the account. See Rule 17a-3(a)(6)(i) under the Exchange Act, 17 CFR 240.17a-3(a)(6)(i).



collected and reported by broker-dealers in compliance with a Commission request pursuant to Rule 17a-25 under the Exchange Act.<sup>319</sup> The proposed Rule would, however, require SRO members to collect and report additional information for each order in a specified uniform format. In addition to the new information, the members also would be required to report most of the information on a real time basis to the central repository, which is not currently required. The Commission anticipates that SRO members would need to either enhance or replace their current order handling, trading, and other systems to be able to collect and report the required order and reportable event information to the central repository as required by the proposed Rule.

The Commission recognizes that the extent to which a particular member would need to make systems changes or replace existing systems would differ depending upon the member's current business operations and systems. The Commission preliminarily believes that members that rely mostly on their own internal order routing and execution management systems would need to make changes to or replace such systems to collect and report the required order and reportable event information to the central repository as required by the proposed Rule. The Commission estimates that there are approximately 1,114 of these types of members.<sup>320</sup> The Commission preliminarily estimates the average initial one-time burden to develop and

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Broker-dealers also are required to keep a record for each cash and margin account they hold, and the name and address of the beneficial owner of each such account. See Rule 17a-3(a)(9) under the Exchange Act, 17 CFR 240.17a-3(a)(9).

<sup>319</sup> See *supra* Section I.A for a detailed discussion of what information is required to be submitted upon request to the Commission pursuant to Rule 17a-25 under the Exchange Act, 17 CFR 240.17a-25.

<sup>320</sup> This number includes members that are clearing brokers-dealers that carry customer accounts; broker-dealers that accept customer monies but do no margin business; introducing brokers that clear proprietary securities transactions; ATSS registered with the Commission; other clearing firms; and registered market makers. This number was derived from annual FOCUS reports filed with the Commission for the year ending in 2008.

implement the needed systems changes to capture the required information and transmit it to the central repository in compliance with the proposed Rule for these members would be approximately 6,530 burden hours.<sup>321</sup> The Commission also preliminarily estimates that these members would, on average, incur approximately \$1.5 million in one-time external costs for hardware and software to implement the systems changes needed to capture the required information and transmit it to the central repository.<sup>322</sup> Therefore, the Commission preliminarily estimates that the average one-time initial burden per member would be 6,530 hours and \$1.5 million, for an estimated aggregate burden of 7,274,420 hours and \$1,671,000,000.

This number would likely overestimate the costs for some of these members and underestimate it for others. For example, it may overestimate the cost for ATSS as opposed to members that engage in a customer and proprietary (or market marking) business, in part because of the narrower business focus of some ATSS.<sup>323</sup> The Commission also recognizes that some or all of these members may contract with one or more outside vendors to provide certain front-end order management systems. The third-party vendor may make changes to its systems

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<sup>321</sup> The Commission derived the total estimated burdens on the following estimates, which reflect the Commission's previous experience with, and burden estimates for, broker-dealer systems changes, and discussions with market participants: (Attorney at 1,240 hours) + (Compliance Manager at 1,540 hours) + (Programmer Analyst at 2,750 hours) + (Business Analyst at 1000 hours) = 6,530 hours.

<sup>322</sup> These estimates are based on the Commission's previous experience with, and cost estimates for, broker-dealer systems changes, and discussions with market participants. See Regulation NMS Reproposing Release, *supra* note 306, at 77480 (discussing costs to implement Rule 611 of Regulation NMS). Although the Commission recognizes that the substance of Rule 611 of Regulation NMS is not the same as the proposed Rule, the Commission preliminarily believes that the scope of the systems changes would be comparable.

These estimated hour burdens and systems costs would include the burden and costs, if any, that would be incurred by members to obtain the required customer information, including beneficial ownership, store it electronically, and transmit it to the central repository.

<sup>323</sup> See Regulation NMS Reproposing Release, *supra* note 306, at 77480.

to permit the members that use the system to capture and provide the required information to the central repository. Likewise, some or all of these members may contract with outside vendors to provide back-office functionality. These third-party vendors may make changes to their systems to permit the members that use the systems to capture and provide the required information to the central repository. The cost of these changes may be shared by the various members that use the systems, and thus may result in a reduced cost to an individual member to implement changes to its own systems to comply with the requirements of the proposed Rule.

Once such a member has established the appropriate systems and processes required for collection and transmission of the required information to the central repository, the Commission estimates that the proposal would impose on each member ongoing annual burdens associated with, among other things, personnel time to monitor each member's reporting of the required data and the maintenance of the systems to report the required data; activity related to adding extra systems capacity to accommodate new order types that would need to be reported to the central repository; or implementing changes to trading systems which might result in additional reports to the central repository. The Commission preliminarily estimates that, on average, it would take a member of a national securities exchange or national securities association approximately 3,050 burden hours per year continued compliance with the proposed Rule.<sup>324</sup>

The Commission also estimates that it would cost, on average, approximately \$756,000 per year per member to maintain the systems connectivity to the central repository and purchase any

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<sup>324</sup> The Commission derived the total estimated burdens on the following estimates, which reflect the Commission's preliminary view that ongoing costs would be approximately half of the costs of developing and implementing the systems to comply with the proposed Rule: (Attorney at 800 hours) + (Compliance Manager at 1,000 hours) + (Programmer Analyst at 500 hours) + (Business Analyst at 750 hours) = 3,050 burden hours.

necessary hardware, software, and other materials.<sup>325</sup> Therefore, the Commission preliminarily estimates that the average ongoing annual burden per member would be approximately 3,050 hours, plus \$756,000 external costs to maintain the systems necessary to collect and transmit information to the central repository, for an estimated aggregate annual burden of 3,397,700 hours and \$842,184,000.

The Commission preliminarily believes that other members generally would rely on functionality provided by third parties to electronically capture the required information and transmit it to the central repository in real time. For purposes of the proposed Rule, the Commission assumes that these members, which could include broker-dealers defined as “small entities” for purposes of the Regulatory Flexibility Act,<sup>326</sup> generally do not clear transactions and may not possess their own internal order routing and execution management systems, but instead rely on third-party providers for such functionality. Further, the Commission assumes that many of these members currently do not themselves report order or trade information and instead rely on their clearing firms or other third parties to do it for them. These smaller members may look for “turn key” systems that could provide the functionality required by the proposed Rule. As such, the Commission preliminarily believes that these members would not undertake a fundamental restructuring of their business to comply with the proposed Rule. Instead, they might continue to rely on their clearing broker-dealer, or they might purchase a standardized software product provided by a third party that would provide the functionality to electronically capture the required information and transmit it to the central repository in real time. The

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<sup>325</sup> This estimate includes an estimated cost of approximately \$10,000 per month to maintain systems connectivity to the central repository, including back-up connectivity. This estimate is based on discussions with a market participant.

<sup>326</sup> See infra Section IX.

Commission estimates that there are approximately 3,006 of these types of members.<sup>327</sup> For these members, Commission staff preliminarily estimates the average external cost to compensate a third party, whether the clearing broker-dealer or other third party, for software that would provide the necessary functionality to electronically capture the required information and transmit it to the central repository, would be approximately \$50,000 per member.<sup>328</sup> In addition, the Commission preliminarily estimates that each of these members, on average, would incur a one-time burden of 140 hours to incorporate this functionality.<sup>329</sup> Therefore, the Commission preliminarily estimates an initial aggregate burden of 420,840 hours and \$150,300,000.

Once such a member has procured the appropriate third party system(s) for collection and transmission of the required information to the central repository, the Commission preliminarily estimates that such a member would continue to incur, on average, an external cost of \$50,000 annually to compensate a third party, whether the clearing broker-dealer or for software that

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<sup>327</sup> This number includes introducing broker-dealers that do not clear transactions. This number excludes non-clearing firms that specialize in direct participation programs; non-clearing firms that sell insurance products; and non-clearing firms that are underwriters and retailers of mutual funds because these firms do not deal in NMS securities. This number was derived from annual FOCUS reports filed with the Commission for the year ending in 2008.

<sup>328</sup> This estimate is based on the Commission's previous experience with, and burden estimates for, broker-dealer systems changes. See Regulation NMS Reproposing Release, supra note 306, at 77480 (discussing costs to implement Rule 611 of Regulation NMS). Although the Commission recognizes that the substance of Rule 611 of Regulation NMS is not the same as the proposed Rule, the Commission preliminarily believes that the scope of the systems changes would be comparable.

<sup>329</sup> The Commission derived the estimated burdens from the following estimates, which are based on prior Commission experience with burden estimates: (Attorney at 50 hours) + (Compliance Manager at 50 hours) + (Programmer Analyst at 40 hours) = 140 hours. These estimated hour burdens and systems costs would include the burden and costs, if any, that would be incurred by members to obtain the required customer information, including beneficial ownership, store it electronically, and transmit it to the central repository.

would provide the necessary functionality to capture the required information and transmit it to the central repository. The Commission also preliminarily estimates that each such member would incur a cost for compliance personnel necessary to oversee continued compliance with the proposed Rule, which would result in 64 burden hours annually for such member.<sup>330</sup> Therefore, the Commission preliminarily estimates an aggregate ongoing burden of 192,384 hours and \$150,300,000 to ensure compliance with the proposed Rule.

The Commission requests specific comments on each of its estimates with respect to the estimated burden and costs on members to comply with the proposed Rule. In particular, the Commission requests comment on the specific types and amount of costs, as well as internal staff burden, that would be incurred to modify members' order handling, trading, and other systems to comply with the proposed Rule. The Commission requests comment whether, and if so how, the estimated costs would be impacted if the members did not have to provide the information in proposed Rule 613(c)(7)(vi) and (vii) (the non-real time information).<sup>331</sup> For instance, would requiring the reporting to the central repository of the account numbers for any subaccounts to which an execution is allocated, and the amount of a commission, if any, paid by the customer and the unique identifier of the broker-dealer(s) to whom the commission is paid, require changes to systems other than order handling and execution systems?

<sup>330</sup> The Commission bases this estimate on a full-time Compliance Manager spending approximately 2 days per quarter of his time on overseeing ongoing compliance with the proposed Rule.

<sup>331</sup> Proposed Rule 613(c)(7)(vi) would require the reporting to the central repository of the following information: (1) the account number for any subaccounts to which the execution is allocated (in whole or part); (2) the unique identifier of the clearing broker or prime broker, if applicable; (3) the unique order identifier of any contra-side order(s); (4) special settlement terms, if applicable; (5) short sale borrow information and identifier; and (6) the amount of a commission, if any, paid by the customer, and the unique identifier of the broker-dealer(s) to whom the commission is paid. Proposed Rule 613(c)(7)(vii) would require the reporting to the central repository of a cancelled trade indicator, if the trade is cancelled.

#### **E. Collection of Information is Mandatory**

Each collection of information discussed above would be a mandatory collection of information.

#### **F. Confidentiality**

The proposed Rule would require that the information to be collected and electronically provided to the central repository would only be available to the national securities exchanges, national securities association and the Commission for the purpose of performing their respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations.<sup>332</sup> Further, the national market system plan submitted pursuant to the proposed Rule would be required to include policies and procedures to ensure the security and confidentiality of all information submitted to the central repository, and to ensure that all plan sponsors and their employees, as well as all employees of the central repository, shall use appropriate safeguards to ensure the confidentiality of such data and shall agree not to use such data for any purpose other than surveillance and regulatory purposes.<sup>333</sup>

#### **G. Retention Period of Recordkeeping Requirements**

National securities exchanges and national securities associations would be required to retain records and information pursuant to Rule 17a-1 under the Exchange Act.<sup>334</sup> Members would be required to retain records and information in accordance with Rule 17a-4 under the Exchange Act.<sup>335</sup>

#### **H. Request for Comments**

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<sup>332</sup> See proposed Rule 613(e)(2).

<sup>333</sup> See proposed Rule 613(e)(4)(i).

<sup>334</sup> 17 CFR 240.17a-1.

<sup>335</sup> 17 CFR 240.17a-4.

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comment to: (1) evaluate whether each proposed collection of information is necessary for the performance of the functions of the agency, including whether the information shall have practical utility; (2) evaluate the accuracy of the agency's estimate of the burden of each proposed collection of information; (3) enhance the quality, utility, and clarity of the information to be collected; and (4) minimize the burden of each collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

#### **VI. Consideration of Costs and Benefits**

The Commission is sensitive to the anticipated costs and benefits of the proposed Rule and requests comments on the costs and benefits of the proposed Rule. The Commission encourages commenters to identify, discuss, analyze, and supply relevant data regarding any such costs or benefits.

##### **A. Benefits**

Proposed Rule 613 would require all national securities exchanges and national securities associations to jointly submit to the Commission an NMS plan to create, implement, and maintain a consolidated audit trail. The proposed consolidated audit trail would capture, in real time, certain information about each order (including quotations) for an NMS security, including the identity of the customer placing the order, and the details of routing, modification, cancellation, and execution (in whole or in part). In effect, an "electronic audit trail report" would be created for every event in the life of the order. The consolidated audit trail would be maintained by a central repository, and all exchanges, FINRA and the Commission would have access to the consolidated audit trail data for regulatory purposes.



The Commission preliminarily believes that proposed Rule 613 would significantly aid each of the exchanges and FINRA in carrying out its respective statutory obligations to be organized and have the capacity to comply, and enforce compliance by its members, with its rules, and with the federal securities laws, rules, and regulations. Likewise, the Commission believes that proposed Rule 613 would significantly aid the Commission in its ability to oversee the exchanges and associations, and to enforce compliance by the members of exchanges and associations with the respective exchange's or association's rules, and the federal securities laws and regulations. The proposed consolidated audit trail also would aid the Commission in its efforts to limit the manipulation of security prices, and to limit the use of manipulative or deceptive devices in the purchase or sale of a security. Further, the proposal would benefit exchanges, FINRA, and Commission staff by improving the ability of exchanges, FINRA and Commission staff to conduct more timely and accurate trading analysis for market reconstructions, complex enforcement inquiries or investigations, as well as inspections and examinations.

Specifically, the Commission preliminarily believes that, as proposed, Rule 613 would enable exchanges and FINRA to more effectively and efficiently detect, investigate, and deter illegal trading activity, particularly cross-market illegal activity, in furtherance of their statutory obligations. In addition, the Commission preliminarily believes that proposed Rule 613 would enhance the ability of the Commission staff in its regulatory and market analysis efforts. The proposed rule would achieve these objectives in several ways. First, proposed Rule 613 would require the central repository to collect the same data on customer and order event information from each exchange, FINRA, and all members of the exchanges and FINRA, in a uniform format. Currently, the scope and format of audit trail information relating to orders and

executions differs, sometimes significantly, among exchanges and FINRA. Thus, by requiring that all exchanges, FINRA and their members submit uniform customer and order event data to the central repository in a uniform format that would more readily allow for consolidation, the proposed Rule would allow regulators to more easily, and in a more timely manner, surveil potential manipulative activity across markets and market participants. The Commission preliminarily believes that this increased efficiency would enhance the ability of SRO and Commission staff to detect and investigate manipulative activity in a more timely manner, whether the activity is occurring on one market or across markets (or across different product classes). Timely pursuit of potential violations can be important in, among other things, seeking to freeze and recover any profits received from illegal activity.

The Commission also preliminarily believes that the proposed consolidated audit trail would enhance the ability of SRO and Commission staff to regulate the trading of NMS securities by requiring that key pieces of information currently not captured in existing audit trails be reported to the proposed consolidated audit trail. For example, proposed Rule 613 would require that the customer that submits or originates an order be identified in the consolidated audit trail. In addition, the proposed Rule would require the assignment of unique identifiers for each order, each customer, and each broker-dealer and SRO that handles an order. Further, the proposed Rule would greatly enhance the ability to track an order from the time of order inception through routing, modification, cancellation, and execution. The Commission preliminarily believes that this information would allow regulators to more easily track potential manipulative activity across markets and market participants, and would place SRO and Commission staff in a better position to surveil whether exchange rules, as well as federal securities laws, rules and regulations, are complied with.

The proposal also would require that most of the required audit trail information be submitted on a real time basis. Most existing audit trails currently collect information on orders at the end of the day, or upon request, rather than in real time.<sup>336</sup> Other order and execution information, such as EBS data and Rule 17a-25 data, is provided to the Commission only upon request. The proposed consolidated audit trail would require that certain information about orders and executions be provided on a real time basis. The Commission preliminarily believes that this requirement could significantly increase the ability of SRO and Commission staff to identify and investigate manipulative activity in a more timely manner.<sup>337</sup>

The Commission preliminarily believes that the proposal also would benefit exchanges, FINRA, and Commission staff by improving the ability of exchanges, FINRA and Commission staff to conduct timely and accurate trading analysis for market reconstructions, complex enforcement inquiries or investigations, as well as inspections and examinations. Today, trading activity is widely dispersed among various market centers, and one or more related orders for one or more securities or other related products may be routed to multiple broker-dealers and more than one exchange, or be executed in the OTC market. Thus, SRO and Commission regulatory staff investigating potentially illegal behavior may have to collect information from multiple broker-dealers and then examine, analyze and reconcile the disparate information provided in widely divergent formats to accurately reconstruct all trading activity during a particular time frame in the course of investigating potentially manipulative activity. Obtaining the necessary order and execution information and undergoing the necessary analysis to determine whether any wrongdoing exists based on the information available today requires substantial investment of time and effort on behalf of regulatory authorities. Under proposed

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<sup>336</sup> See supra Sections I.C., I.D., II.A., and V.A.5.

<sup>337</sup> See supra Section III.D.1.

Rule 613, regulatory authorities would be able to access all information about events in the life of an order or related orders, and obtain critical information identifying the customer (or beneficial owner) behind the order(s) directly from the central repository in a uniform format. Thus, the Commission preliminarily believes that ability of SRO and Commission staff to conduct timely and accurate trading analysis for market reconstructions, complex enforcement inquiries and investigation, as well as inspections and examinations, would be significantly improved.

The Commission also preliminarily believes that the proposal would benefit SROs, as well as the NMS for NMS securities, by ultimately reducing some regulatory costs, which may result in a more effective re-allocation of overall costs. For example, by providing a more comprehensive and searchable database, the Commission preliminarily believes that the consolidated audit trail would significantly decrease the amount of time invested by SRO staff to determine whether any illegal activity is occurring either on one market or across markets. Currently, SRO regulatory staff may need to submit multiple requests to its members during the course of an investigation into possible illegal activity, or submit multiple requests to ISG to obtain audit trail information from other SROs about trading in a particular security, and then commit significant staff time to collating and analyzing the data produced. The proposal would benefit the Commission in similar respects. For example, Commission staff often must submit numerous requests to members after the Commission receives information from equity cleared reports in an attempt to identify the ultimate customer (or beneficial account holder) that entered the order or orders in question. Substantial Commission staff resources currently are invested in analyzing the data that is received in response to these requests.

Under proposed Rule 613, SRO regulatory staff would have immediate, easily searchable access to the consolidated audit trail data through the central repository for purposes of conducting surveillance, investigations, and enforcement activities. Commission staff likewise would have more efficient and timely access for purposes of conducting risk assessments of referrals received, investigations, and enforcement activities, and for purposes of conducting market reconstructions or other analysis. Thus, the Commission preliminarily believes that the proposal would benefit SRO and Commission staff, as well as the market for NMS securities as whole, by providing immediately accessible audit trail information to regulatory staff, which would in turn reduce staff time and effort that would otherwise be needed to collect and analyze audit trail information and allow such staff time and effort to be redirected to more effective uses, possibly even allowing the staff to engage in more investigations. In other words, if the costs per investigation decreased because of efficiencies in the proposed consolidated audit trail information, SRO or Commission staff may be able to review and investigate a greater amount of suspicious activity.

Likewise, the Commission preliminarily believes that proposed Rule 613 would benefit the exchanges, FINRA, the Commission, and the members of SROs, as well as investors and the public interest, by reallocating the overall cost of regulating the markets for NMS securities on an ongoing basis toward more efficient regulation. For instance, the Commission preliminarily believes that the proposed consolidated audit trail would eliminate the need for certain SRO and Commission rules that currently mandate the collection and provision of information, at least with respect to NMS securities. As noted above, many exchanges and FINRA each have their own disparate audit trail rules. Thus, a member of the various exchanges and FINRA could be subject to the audit trail rules of, and be required to submit different information to, more than

one exchange and FINRA. The Commission intends that the proposed consolidated audit trail replace the need to have disparate SRO audit trail rules. If proposed Rule 613 were adopted, and the consolidated audit trail was implemented, the Commission preliminarily believes that the exchanges and FINRA would not need to have separate and disparate audit trail rules that apply to NMS securities applicable to their members. Thus, the Commission preliminarily believes that the proposed consolidated audit trail would ultimately result in the ability of SROs to repeal their existing audit trail rules because SRO audit trail requirements would be encompassed within proposed Rule 613. Similarly, the proposed consolidated audit trail also may render duplicative and thus unnecessary certain data obtained from the EBS system pursuant to Rule 17a-25 (and the SRO rules implementing the EBS system), and from the equity cleared data, at least as it relates to NMS securities. SRO and Commission staff instead would be able to access the audit trail information for every order directly from the central repository.<sup>338</sup>

The Commission requests comment on any ongoing cost savings to SROs or their members that could be achieved by the proposal. Are there any other systems or technologies that could be replaced by the proposed audit trail? Would additional Commission action be required to achieve cost savings due to redundant rules or systems? Are there any new systems or technology requirements that could offset these potential cost savings? To what extent would any cost savings amount to a reallocation of resources towards more effective or efficient uses? Please provide specific examples. The Commission also requests comment as to whether the proposed Rule should require the NMS plan to include provisions relating to transition from the existing audit trails to the proposed consolidated audit trail.

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<sup>338</sup> The Commission notes that, if the proposed Rule were adopted, the SROs would need to consider the continued need for their existing audit trail rules until such time that their members begin complying with the requirements of the proposed Rule.

As discussed above, the Commission preliminarily believes that the proposal would significantly enhance the ability of SRO staff to efficiently and effectively regulate their market and their members, including detecting and investigating potential manipulative activity. The Commission also preliminarily believes that the proposed consolidated audit trail would benefit the Commission in its regulatory and market analysis efforts. More timely detection and investigation of potential manipulative activity may lead to greater deterrence of future illegal activity if potential wrongdoers perceive a greater chance of regulators identifying their activity in a more timely fashion. To the extent investors consider the improvement in regulators' ability to detect and investigate wrongdoing as significant to their investment decisions, investor trust, which is a component of investor confidence, is improved and investors may be more willing to invest in the securities markets.<sup>339</sup> An increase in investor participation in the securities markets, at least to the extent that the increase is allocated efficiently, can potentially benefit the securities markets as a whole, through better capital formation. Thus, the Commission preliminarily believes that the proposed consolidated audit trail would benefit the NMS for NMS securities by encouraging more efficient and potentially a higher level of capital investment.

The Commission requests comment on how the proposal would impact investor protections and investor confidence. In particular, would the consolidated audit trail better align investor protections to the expectations that investors have about their protections? What would be the economic effect of the potential changes to investor protections or to better alignment of those protections with investor expectations? Would any of the anticipated benefits of the proposed Rule be mitigated if market participants alter their trading behavior, such as by shifting their trading activity to products or markets that do not require the capture of customer

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<sup>339</sup> See Guiso, Sapienza, and Zingales, "Trusting the Stock Market," available at <http://ssrn.com/abstract=811545>.

information to avoid compliance with the requirements of the proposed Rule? If so, please explain how so, and what, if any, steps the Commission should take in response.

The Commission also preliminarily believes that proposed Rule 613 would enhance the overall reliability of audit trail data that is available to the Commission and SRO regulatory staff. Because the proposed Rule would require that the NMS plan include policies and procedures, including standards, to be used by the plan processor to ensure the timeliness, accuracy, and completeness of the audit data submitted to the central repository, there would be an automatic check on the incoming audit trail data submitted by exchanges and FINRA, and their members, for reliability and accuracy. The Commission expects that these policies and procedures would include validation parameters that would need to be met before audit trail data would be accepted into the central repository, and that the central repository would reject data that did not meet certain validation parameters, and require resubmission of corrected data. Thus, the Commission preliminarily believes that the integrity of audit trail information available to the Commission and to the regulatory staff of the exchanges and FINRA would be enhanced and safeguarded by the provisions applicable to the central repository pursuant to proposed Rule 613.

#### **B. Costs**

As discussed below, the Commission acknowledges that there likely would be significant up-front costs to implement the proposal. However, the Commission preliminarily believes that SRO and Commission staff, as well as SRO members, would realize other cost savings and benefits.

##### **1. Creation and Filing of NMS Plan**

The proposed Rule would require the exchanges and FINRA to jointly develop and file an NMS plan to create, implement and maintain a consolidated audit trail that would capture



customer and order event information in real time for all orders in NMS securities, across all markets, from the time of order inception through execution, cancellation or modification.<sup>340</sup>

Exchanges and FINRA would be expected to undertake any joint action necessary to develop and file the NMS plan, and there would be attendant costs in doing so. For example, the Commission anticipates that exchange and FINRA staff would need to meet and draft the required terms and provisions of the NMS plan.<sup>341</sup> The Commission preliminarily believes that the existing exchanges and FINRA would incur an aggregate one-time cost of approximately \$3,503,100 to prepare and file the NMS plan.<sup>342</sup> Once exchanges and FINRA have established the NMS plan,

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<sup>340</sup> See proposed Rule 613(c)(1), (c)(3), (c)(7); see also *supra* Sections III.A., III.B., III.D., and V.A.5.

<sup>341</sup> As discussed above in Section III, these required provisions include provisions relating to: a governance structure to ensure the fair representation of the plan sponsors; administration of the plan, including the selection of the plan processor; the admission of new sponsors of the NMS plan and the withdrawal of existing sponsors from the plan; the percentage of votes required by the plan sponsors to effectuate amendments to the plan; the manner in which costs of operating the central repository would be allocated among the exchanges and FINRA, including a provision addressing the manner in which costs would be allocated to new sponsors of the plan; the appointment of a Chief Compliance Officer; the provision stating that by subscribing to and submitting the plan to the Commission each plan sponsor agrees to enforce compliance by its members with the provisions of the plan; and the provision requiring the creation and maintenance by the central repository of a method of access to the consolidated data that includes search and reporting functions. See proposed Rules 613(b), 613(e)(3), and 613(g)(3). The NMS plan also would be required to include policies and procedures, including standards, to be used by the plan processor to ensure the security and confidentiality of all information submitted to the central repository; to ensure the timeliness, accuracy, and completeness of the data provided to the central repository; to require the rejection of data provided to the central repository that does not meet the validation parameters set out in the plan and the re-transmission of corrected data; and to ensure the accuracy of the processing of the data provided to the central repository. See proposed Rule 613(e)(4).

<sup>342</sup> This figure includes internal personnel time and external legal costs. Commission staff estimates that each exchange and association would expend (400 Attorney hours x \$305 per hour) + (100 Compliance Manager hours x \$258 per hour) + (220 Programmer Analyst hours x \$193 per hour) + (120 Business Analyst hours x \$194 per hour) = \$213,540. The \$305 per-hour figure for an Attorney; the \$258 per hour figure for a Compliance Manager; the \$193 per hour figure for a Programmer Analyst; and the \$194 per hour figure for a Business Analysis (Intermediate) are from SIFMA's Management &

the Commission estimates that, on average, each exchange and FINRA would incur a cost of \$48,384 per year to ensure that the plan is up to date and remains in compliance with the proposed Rule,<sup>343</sup> for an estimated aggregate annual cost of \$725,760.

In estimating the costs for creation of the NMS plan, the Commission considered exchange and FINRA staff time necessary for preparing and filing the plan with the Commission. The Commission also considered the cost of outsourced legal services. The Commission requests comment on whether there are additional costs that would contribute to the expense of creating and filing the NMS plan. Please describe any such cost in detail and provide an estimate of the costs. In estimating the ongoing costs of the NMS plan, the Commission considered exchange and FINRA staff time necessary for periodically reviewing the plan in light of current market trends and technology. The Commission requests comment on these estimates and what types of costs would be incurred to keep the plan up to date.

## 2. Synchronizing Clocks

The proposed Rule would require each exchange and FINRA, and the members of each exchange and FINRA, to synchronize its business clocks that are used for the purpose of recording the date and time of any reportable event that must be reported pursuant to the proposed Rule to the time maintained by the National Institute of Standards and Technology,

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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. Commission staff also estimates that each exchange and association would outsource, on average, 50 hours of legal time, at an average hourly rate of \$400. Thus, the Commission preliminarily estimates, on average, a total cost of \$233,540 per SRO. See *supra* Section V.D.1.a. (discussing PRA costs for developing and filing the NMS plan).

<sup>343</sup> Commission staff estimates that annually each exchange and association would expend (64 Attorney hours x \$305 per hour) + (64 Compliance Manager hours x \$258 per hour) + (64 Programmer Analyst hours x \$193 per hour) = \$48,384, to ensure that the NMS plan is up to date and remains in compliance with the proposed Rule. See *supra* note 301.

consistent with industry standards.<sup>344</sup> As part of the initial implementation of the consolidated audit trail, the exchanges, FINRA and their members therefore would have to ensure that their business clocks are synchronized with the time maintained by the National Institute of Standards and Technology. The proposed Rule also would require that the NMS plan provide for the annual evaluation of the synchronization time standard to determine whether it should be shortened, consistent with industry standards.<sup>345</sup>

The Commission recognizes that the cost to each SRO and member to synchronize their clocks consistent with the proposed requirements would vary depending upon the SRO or member's existing systems. The Commission preliminarily believes, however, that most SROs and their members currently synchronize their clocks, and that therefore the SROs and their members would not incur significant costs to comply with this requirement.<sup>346</sup> The Commission recognizes that each individual member or SRO's costs may vary depending upon their current synchronization practices, their business structure, their order management and trading systems, and their geographic diversity. The Commission preliminarily estimates that an SRO or member that would need to make system changes to comply with the requirement would incur an average one-time initial cost of approximately \$9,650.<sup>347</sup>

The Commission also preliminarily estimates that there would be an average ongoing annual cost of approximately \$11,580 to each exchange, FINRA, and member to synchronize

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<sup>344</sup> See proposed Rule 613(d)(1).

<sup>345</sup> See proposed Rule 613(d)(2).

<sup>346</sup> See CHX Rule 4, Interpretations and Policies .02; FINRA Rule 7430; NYSE and NYSE Amex Equities Rule 123, Supplementary Material .23; NYSE and NYSE Amex Equities Rule 132A; and NYSE Arca Options Rule 6.20.

<sup>347</sup> Commission staff estimates that, on average, each exchange, association, and member would expend 50 hours of information technology time, at a cost of \$193 per hour to make systems changes to comply with the requirement that clocks be synchronized. This estimate is based on discussions with market participants.

their business clocks to the time maintained by the National Institute of Standards and Technology, consistent with industry standards.<sup>348</sup> Further, the Commission preliminarily estimates that there would be an average cost to exchanges, FINRA and their members of approximately \$6,192 per SRO or member to annually evaluate the synchronization time standards to determine whether it should be shortened, consistent with industry standards.<sup>349</sup>

As stated above, the Commission preliminarily believes that the costs to the SROs and their members associated with synchronizing their clocks would not be significant because most SROs and their members currently synchronize their clocks. The Commission requests comments on whether commenters agree. If not, what costs would be incurred? Please be specific as to the type of changes necessary and the costs of making them. Further, the proposed Rule would require that all SROs and their members synchronize to same time standard and to the same level of accuracy. The Commission requests comment on its estimate of the cost to SROs and their members of initializing synchronizing business clocks, the ongoing costs for maintaining accurate synchronization, and the costs associated with annual evaluation of the synchronization time standard. Would SROs or their members incur costs, and if so, what types of costs?

### 3. Costs to Provide Information

As discussed above in Section V.A.5, the Commission preliminarily believes that the proposed Rule would require the collection and reporting on a real time basis of some information that national securities exchanges and national securities associations already record

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<sup>348</sup> Commission staff estimates that each exchange, association and member would expend approximately five hours of information technology time, per month, at \$193 per hour. This estimate is based on discussions with industry participants.

<sup>349</sup> This estimate assumes that each SRO or member would expend (16 Programmer Analyst hours x \$193 per hour) + (16 Business Analyst hours x \$194 per hour) = \$6,192 to carry out this annual evaluation.

to operate their business, and are required to maintain in compliance with Section 17(a) of the Exchange Act and Rule 17a-1 thereunder.<sup>350</sup> However, the proposed Rule would require each SRO to collect and report additional and more detailed information, and to report the information to the central repository in real time in a specified format. Based on discussions with SROs, the Commission anticipates that exchanges would need to enhance or replace their current systems to be able to comply with the proposed information collection and reporting requirements of the proposed Rule.

Likewise, the Commission preliminarily believes the proposed Rule would require the collection of much of the information that registered broker-dealers already maintain in compliance with existing regulations.<sup>351</sup> The proposed Rule, however, would require members to collect additional information for each order and, in addition to the new information, the members also would be required to report most of the information on a real time basis to the central repository in a specified uniform format. Based on discussions with members, the Commission anticipates that the SRO members would need to enhance or replace their current order handling, trading and other systems to be able to collect and report the required order and reportable event information to the central repository as required by the proposed Rule.

The Commission recognizes that the extent to which a particular SRO or member would need to make systems changes would differ depending upon the SRO's market structure (e.g., floor vs. electronic) and systems, or the member's current business operations and systems. The

<sup>350</sup> 15 U.S.C. 78q(a) *et. seq.*; 17 CFR 240.17a-1. Rule 17a-1 requires an exchange or association to keep and preserve at least one record of all documents or other records that shall be received by it in the course of its business as such and in the conduct of its self-regulatory activity. This would include records of the receipt of all orders entered into their systems, as well as records of the routing, modification, cancellation, and execution of those orders. The Commission understands that SROs have automated this process and thus keep these records in electronic format.

<sup>351</sup> See *supra* notes 317 to 319 and accompanying text.

Commission preliminarily estimates that the average one-time, initial cost to exchanges and FINRA to put in place the systems necessary to identify, collect and transmit the consolidated audit trail information to the central repository would total approximately \$5 million per SRO,<sup>352</sup> for an aggregate estimated cost of \$75 million for all SROs. In estimating this cost, the Commission has considered SRO staff time necessary to build new systems or enhance existing systems to comply with the proposed Rule.<sup>353</sup> In addition, the Commission estimated costs for system hardware, software, and other materials.<sup>354</sup> What other types of costs might SROs incur? Please be specific in your response.

Once an SRO has implemented the changes necessary to collect and transmit the required information to the central repository as required by the proposed Rule, the Commission estimates that each SRO would incur, on average, an annual ongoing cost of \$2.5 million to ensure compliance with the proposed Rule,<sup>355</sup> for an estimated ongoing annual aggregate cost of \$37.5 million for all SROs.

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<sup>352</sup> The Commission based this estimated cost on the Commission's previous experience with, and burden estimates for, SRO systems changes and discussions with market participants. See Regulation NMS Reproposing Release, *supra* note 306, at 77480 (discussing costs of implementing Rule 611 of Regulation NMS). Although the Commission recognizes that the substance of Rule 611 is not the same as the proposed Rule, the Commission preliminarily believes that the scope of systems changes would be comparable.

<sup>353</sup> Commission staff estimates that each exchange and association would expend (100 Attorney hours x \$305 per hour) + (80 Compliance Manager hours x \$258 per hour) + 1,960 Programmer Analyst hours x \$193 per hour) + 60 Business Analyst hours x \$194) = \$441,060 to develop and implement the systems needed to capture the required information and transmit it. In addition, the Commission estimates that each exchange and association would expend 40 hours of outsourced legal time at an average rate of \$400 per hour. See *supra* note 305.

<sup>354</sup> Commission staff estimates that the cost for system hardware, software, and other materials would be \$4,542,940. See *supra* note 306 and accompanying text.

<sup>355</sup> Commission staff estimates that each exchange and association would expend

The Commission understands that many members, particularly smaller members, currently rely on third parties to report information required to be reported pursuant to SRO audit trail or other rules. For example, a member that is an introducing broker who sends all of its customer order flow to a clearing broker currently may rely on that clearing broker for reporting purposes. The Commission preliminarily believes that these members would not undertake a fundamental restructuring of their business to comply with the proposed Rule. Instead, they might continue to rely on their clearing broker-dealer, or they might look for the ability to purchase a standardized software product provided by a third party that would provide the functionality to electronically capture the required information and transmit it to the central repository in real time. The costs of this approach are likely to be significantly lower than the costs to a member that enhances its own systems, or creates new systems, to comply with the proposed requirements to report information to the central repository. The Commission estimates that there are approximately 3,006 of these types of members, and that the average cost to such members to compensate a third party, whether a clearing broker-dealer or other third party, for software that would provide the necessary functionality to electronically capture the required information and transmit it to the central repository would be approximately \$50,000 per member.<sup>356</sup> In addition, the Commission estimates that, on average, each member would

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(1,500 Attorney hours x \$305 per hour) + (1,600 Compliance Manager hours x \$258 per hour) + (1,375 Programmer Analyst hours x \$193 per hour) + (500 Business Analyst hours x \$194 per hour) to ensure that the systems technology is up to date and remains in compliance with the proposed Rule, for a total of \$1,250,675. In addition, Commission staff estimates that each exchange and association would expend approximately \$1.25 million on system hardware, software, connectivity and other materials. These estimates reflect the preliminary view that ongoing costs to maintain compliance with the proposed Rule would be half of the initial costs. See supra notes 307 and 308.

<sup>356</sup> See supra note 328. The Commission based this estimated cost on the Commission's previous experience with, and burden estimates for, broker-dealer systems changes. See Regulation NMS Reproposing Release, supra note 306, at 77480 (discussing costs of

incur a one-time cost of \$35,870 to incorporate the new functionality into its existing systems to ensure compliance with the proposed Rule.<sup>357</sup> Thus, the Commission preliminarily estimates that each of these members would incur, on average, a one-time cost of \$85,870, for an estimated aggregate cost of \$258,125,220.

The Commission also preliminarily estimates that each of these members would continue to incur, on average, annual costs of \$66,512 to ensure continued compliance with the proposed Rule.<sup>358</sup>

Do commenters believe that smaller members would likely rely on third parties to provide a functionality that would provide required data to the central repository? Why or why not? Would it be more cost effective for a small member to enhance existing systems or create new systems to comply with the proposed Rule? Why or why not? What would be the costs associated with each approach? Should members that currently rely on another party to report, such as their clearing broker, be able to have their clearing firms report on their behalf? Why or why not? How would allowing third-party reporting impact the ability to report data in real time? Would the manner in which these members currently maintain customer information

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implementing Rule 611 of Regulation NMS). Although the Commission recognizes that the substance of Rule 611 is not the same as the proposed Rule, the Commission preliminarily believes that the scope of systems changes would be comparable.

<sup>357</sup> Commission staff estimates that annually each of these types of members would expend (50 Attorney hours x \$305 per hour) + (50 Compliance Manager hours x \$258 per hour) + (40 Information Analyst hours x \$193 per hour) = \$35,870 to incorporate the new functionality into its existing systems.

These costs would include any systems or other changes necessary to obtain the required customer information, including the identity of the beneficial owner, and electronically storing it for transmittal to the central repository with the order information.

<sup>358</sup> This estimate is based on a cost of \$50,000 per year to compensate a third party for the functionality to capture the required information and transmit it to the central repository, and a cost of \$16,512 for personnel time to oversee compliance with the proposed Rule (64 hours Compliance Manager x \$258 per hour). See supra note 330.



create practical difficulties for providing the beneficial ownership information, or additional burdens that have not been taken into account in estimating costs? For example, is customer information stored electronically? What is the impact of the manner in which this information is currently stored on the Commission's cost estimates?

The Commission preliminarily estimates that there are 1,114 members that would undertake their own development changes to implement the proposed Rule.<sup>359</sup> The Commission preliminarily estimates that the average one-time, initial cost to these members for development, including programming and testing of the systems necessary to identify, collect and transmit the consolidated audit trail information to the central repository, would be approximately \$3 million per member,<sup>360</sup> for an estimated aggregate cost of \$3,342,000,000. This number would likely overestimate the costs for some of these members and underestimate it for others. For example, it likely overestimates the cost for ATSS as opposed to broker-dealers that have a customer and proprietary, or market-making, business, in part because of the narrower business focus of some ATSS. The Commission recognizes that some of these members may contract with one or more

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<sup>359</sup> See supra Section V.D.2 and note 320.

<sup>360</sup> Commission staff estimates that each member would expend (1,240 Attorney hours x \$305 per hour) + (1,540 Compliance Manager hours x \$258 per hour) + (2,750 Programmer Analyst hours x \$193 per hour) + (1,000 Business Analyst hours x \$194 per hour) = \$1,500,270 to develop and implement the systems needed to capture the required information and transmit it. In addition, the Commission estimates that the cost for system hardware, software, and other materials would be approximately \$1.5 million. This estimate is based on the Commission's previous experience with, and burden estimates for, broker-dealer systems changes. See Regulation NMS Reproposing Release, supra note 306, at 77480 (discussing cost estimates for implementing Rule 611 of Regulation NMS). Although the Commission recognizes that the substance of Rule 611 is not the same as the proposed Rule, the Commission preliminarily believes that the scope of systems changes would be comparable.

These costs would include any systems or other changes necessary to obtain the required customer information, including the identity of the beneficial owner, and electronically storing it for transmittal to the central repository with the order information.

outside vendors to provide certain front-end order management systems. The third-party vendor may make changes to its systems to permit the members that use the system to capture and provide the required information to the central repository. Likewise, some of these members may contract with outside vendors to provide back-office functionality. These third-party vendors may make changes to their systems to permit the members that use the systems to capture and provide the required information to the central repository. The cost of these changes may be shared by the various members that use the systems, and thus may result in a reduced cost to an individual member to implement changes to its own systems to comply with the requirements of the proposed consolidated audit trail.

The Commission requests comment on this estimate. Specifically, what types of costs would members incur building new systems, or enhancing existing systems, to comply with the proposed Rule? Would members need to expand their capacity as part of any systems upgrades? What would be the costs associated with this? Would the manner in which these members currently maintain customer information create practical difficulties for providing the beneficial ownership information, or additional burdens that have not been taken into account in estimating costs? For example, is customer information stored electronically? What is the impact of the manner in which this information is currently stored on the Commission's cost estimates?

Once these members have largely implemented the changes necessary to collect and report the required order and reportable event information to the central repository as required by the proposed Rule, the Commission estimates that each such member would incur, on average, an annual ongoing cost of approximately \$1.5 million,<sup>361</sup> for an estimated aggregate ongoing cost

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<sup>361</sup> Commission staff estimates that each member would expend (800 Attorney hours x \$305 per hour) + (1,000 Compliance Manager hours x \$258 per hour) + (500 Programmer Analyst hours x \$193 per hour) + (750 Business Analyst hours x \$194 per hour) =

of \$ 1,671,000,000. These estimates would cover the costs associated with continued compliance with the proposed Rule.<sup>362</sup>

The Commission requests comment on what ongoing costs SROs and their members would incur to continue to collect and report the required information in compliance with the proposed Rule. What types of costs would be included? Are there differences in the costs that SROs and their members would incur? Why or why not.

The proposal would require the transmission of information in real time to the central repository. The Commission preliminarily believes that this approach would have greater benefits and would be lower cost than an alternative of transmitting all reports in batch mode. Real time submission could simply require a "drop copy" of a reportable event be sent to the central repository at the same time that the reportable event is otherwise occurring. Batching, however, would require the build up of reports to be sent periodically, and the amount of data sent in a batch could be significantly larger than the data sent in real time. The Commission requests comment on the technology requirements and other costs of real time transmission of information versus periodically batching the reports. Would real time reporting be more or less costly than batch reporting? Please explain with specificity why or why not and provide cost estimates. If real time reporting would be more expensive, are the greater costs justified by the benefits of real time reporting described above? If batch reporting is the better alternative, what should be the frequency of the batch reporting and why? Does the answer depend on the type of security? The Commission also requests comment on what types of systems changes SROs and

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\$744,000 to ensure that the systems technology is up to date and remains in compliance with the proposed Rule. In addition, Commission staff estimates that each member would expend approximately \$756,000 on system hardware, software, connectivity and other materials. These estimates reflect the preliminary view that ongoing costs to maintain compliance with the proposed Rule would be half of the initial estimated costs.

<sup>362</sup>

See supra Section V.D.2.

members would need to make to implement the proposed Rule and NMS plan requirements, and the attendant costs. What specific types or items of information, if any, would be required to be reported to the central repository by a member that would not already be collected and maintained in an automated format?

#### 4. Cost of Enhanced Surveillance Systems

Pursuant to the proposed Rule, exchanges and FINRA also would be required to develop and implement a surveillance system, or enhance existing surveillance systems, reasonably designed to make use of the consolidated information collected through the proposed consolidated audit trail.<sup>363</sup> The Commission preliminarily estimates that the average one-time cost to implement this requirement would be approximately \$10 million for each exchange and FINRA, for an estimated aggregate cost of \$150 million.<sup>364</sup> The Commission also estimates, on average, ongoing annual costs associated with the enhanced surveillance would be approximately \$2,610,600,<sup>365</sup> for an estimated aggregate, ongoing cost of \$39,159,000. Based on discussions with market participants, the Commission recognizes that these estimated costs may vary, perhaps significantly, based on the market model utilized by a particular SRO. For certain SROs, these figures may overestimate the costs associated with developing or enhancing surveillance systems, while for others, it may underestimate the costs. The Commission requests

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<sup>363</sup> See proposed Rule 613(f).

<sup>364</sup> This estimate is based on discussions with market participants. This estimate does not separately break out personnel time versus system costs.

<sup>365</sup> Commission staff estimates that each member would expend (3,600 Senior Compliance Examiner hours x \$212 per hour) and (1,800 Information Analyst hours x \$193 per hour) to operate and monitor the enhanced surveillance systems and carry out surveillance functions. In addition, Commission staff estimates that each member would expend approximately \$1.5 million on system hardware, software, connectivity and other technology per year on an on-going basis for this purpose. These estimates are based on discussions with a market participant.

comment on whether these figures accurately estimate the costs for developing or enhancing surveillance systems to comply with the proposed Rule for the SROs. Would these figures be lower or higher for SROs whose trading systems are fully electronic? Would the cost estimates be higher or lower for those SROs that have a trading floor? What other considerations would impact individual SRO costs? Please be specific in your response.

The Commission also requests comment on whether SROs would be able to enhance their existing surveillance and regulation to make use of the proposed consolidated information or would they need to develop new surveillance systems to comply with the proposed Rule? How would SROs enhance their current surveillance systems? What would be the costs associated with updating current systems as opposed to developing new surveillance systems? Would it be more cost efficient to establish coordinated surveillance across exchanges and FINRA, rather than having each SRO be responsible for surveillance on its own market using the consolidated data? What would be the costs associated with developing consolidated cross-market surveillance?

#### 5. Central Repository System

The central repository would be responsible for the receipt, consolidation, and retention of all the data required to be submitted by the exchanges and FINRA, and their members. The proposed Rule also would require that the central repository collect and retain on a current and continuous basis the NBBO for each NMS security, transaction reports reported pursuant to an effective transaction reporting plan, and last sale reports reported pursuant to the OPRA Plan. The central repository would be required to maintain the NBBO and transaction data in a format compatible with the order and event information collected pursuant to the proposed Rule. Further, the central repository would be required to retain the information collected pursuant to

paragraphs (c)(7) and (e)(5) of the proposed Rule in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years. The information shall be available immediately, or if immediate availability cannot reasonably and practically be achieved, any search query must begin operating on the data not later than one hour after the search query is made.<sup>366</sup>

The central repository thus would need its own system(s) to receive, consolidate, and retain the electronic data received from the plan sponsors and their members, as well as to collect and retain the NBBO and last sale data. The system would be required to be accessible and searchable by the sponsors and the Commission for regulatory purposes,<sup>367</sup> with validation parameters allowing the central repository to automatically check the accuracy and the completeness of the data submitted, and reject data not conforming to these parameters. It is anticipated that the costs of development and operation of the central repository would be shared among the plan sponsors. The Commission preliminarily estimates a one-time initial cost to create the central repository, its systems and structure, of approximately \$120 million for an average cost of approximately \$8 million per plan sponsor.<sup>368</sup>

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<sup>366</sup> See proposed Rule 613(e)(6).

<sup>367</sup> The proposed Rule would require that the central processor create and maintain a method of access to the consolidated data. See proposed Rule 613(e)(3). The Rule requires that this method of access would be designed to include search and reporting functions to optimize the use of the consolidated data. The cost of creating a method of access to the consolidated audit trail data is included within the overall systems cost estimate.

<sup>368</sup> Commission staff estimates that each exchange and association would expend (3,000 Attorney hours x \$305 per hour) + (4,000 Compliance Manager hours x \$258 per hour) + (7,500 Programmer Analyst hours x \$193 per hour) + (3,000 Business Analyst hours x \$194 per hour) = \$3,976,500 to create the central repository. In addition, the Commission estimates that the cost per exchange or association for system hardware, software, and other materials would be approximately \$4 million. See *supra* Section V.D.1.d. and note 309.

Does this estimate accurately reflect SRO staff time needed to create the central repository as well as the costs for any hardware, software and other materials required? Are there other cost components to creating the central repository the Commission should consider? Is the creation of a central repository as described in the proposed Rule for collection and consolidation of data the most cost effective way to achieve the objective of creation of a consolidated audit trail? Are there other alternatives the Commission should consider? Please describe the costs associated with any alternatives described.

Once the plan sponsors have established the systems necessary for the central repository to receive, consolidate, and retain the required information, the Commission estimates that ongoing annual costs to operate the central repository would be approximately \$100 million,<sup>369</sup> which would be approximately \$6.6 million per year per plan sponsor. The Commission also estimates that each plan sponsor would incur, on average, ongoing costs of \$48,384 per year for

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This estimate includes the estimated costs that each exchange and association would incur for software and hardware costs related to systems development. This cost estimate also would encompass (1) costs related to engaging in an analysis and formal bidding process to choose the plan processor, and (2) any search undertaken to hire a CCO. See proposed Rule 613(a)(3)(i) (the plan sponsors would be required to select a person to act as a plan processor for the central repository no later than two months after the effectiveness of the NMS plan) and 613(b)(5) (the plan sponsors would be required to appoint a CCO to regularly review the operation of the central repository to assure its continued effectiveness in light of market and technological developments, and make any appropriate recommendations for enhancements to the nature of the information collected and the manner in which the information is processed).

<sup>369</sup> See supra Section V.D.1.d. This cost estimate includes ongoing costs for operating the central repository, including the cost of systems and connectivity upgrades or changes necessary to receive, consolidate, and retain and store the reported order information from SROs and their members; the cost, including storage costs, of collecting and maintaining the NBBO and transaction data in a format compatible with the order and event information collected pursuant to the proposed Rule; the cost of monitoring the required validation parameters; the cost of compensating the plan processor; and an ongoing annual cost of \$703,800 to compensate the CCO. See supra note 312.

actions taken to review the operation and administration of the central repository.<sup>370</sup> In addition, the Commission estimates that the central repository would incur an ongoing cost of \$1,370 per year to purchase the NBBO and last sale data feeds from the SIPs.<sup>371</sup>

The Commission request comment on these estimated costs. Does this estimate accurately reflect the cost of storing data in a convenient and usable standard electronic data format that is directly available and searchable, without any manual intervention, for a period of not less than 5 years? Would these costs estimates change if the scope of the consolidated audit trail were expanded to include equity securities that are not NMS securities; corporate bonds, municipal bonds, and asset-backed securities and other debt instruments; credit default swaps, equity swaps, and other security-based swaps? What systems or other changes would be necessary to accommodate these other products? How would those changes impact costs?

## 6. SRO Rule Filings

The exchanges and FINRA also would be required to file proposed rule changes to implement the provisions of the NMS plan with respect to their members.<sup>372</sup> The Commission notes that the exchanges and FINRA would be able to use the NMS plan as a roadmap to draft the content of their required proposed rule changes. The Commission also notes that the rule filing format and process is not new to the exchanges or to FINRA.<sup>373</sup> The Commission

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<sup>370</sup> Commission staff estimates that annually each exchange and association would expend (64 Attorney hours x \$305 per hour) + (64 Compliance Manager hours x \$258 per hour) + (64 Programmer Analyst hours x \$193 per hour) = \$48,384 to ensure and review the operation and administration of the central repository. See supra note 343 and accompanying text.

<sup>371</sup> See supra Section V.D.1.e.

<sup>372</sup> See proposed Rule 613(g)(1).

<sup>373</sup> The Commission notes that, for its 2009 fiscal year (October 1, 2008 to September 30, 2009), the then existing twelve exchanges and FINRA filed approximately 1,308



estimates that the aggregate cost of each SRO filing a proposed rule change to implement the NMS plan to be approximately \$590,175.<sup>374</sup>

#### 7. Expansion of the proposed consolidated audit trail

The proposed Rule would require the plan sponsors to jointly provide to the Commission a report outlining how the sponsors would incorporate into the consolidated audit trail information with respect to: (1) equity securities that are not NMS securities; (2) debt securities; and (3) primary market transactions in equity securities that are not NMS securities, in NMS stocks, and in debt securities. The sponsors would be required to address, among other things, details for each order and reportable events that they would recommend requiring to be provided; which market participants would be required to provide the data; an implementation schedule; and a cost estimate. Thus, the exchanges and FINRA would need to, among other things, undertake an analysis of technological and computer system acquisitions and upgrades that would be required to incorporate such an expansion. The Commission preliminarily estimates that the one-time cost to the exchanges and FINRA to create and file with the Commission a

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proposed rule changes in the aggregate pursuant to Section 19(b) and Rule 19b-4 thereunder.

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This figure was calculated as follows: (129 Attorney hours x \$305) = \$39,345 x 15 SROs = \$590,175. Commission staff estimates that each exchange and association would expend approximately 129 hours of legal time x \$305 to prepare and file a complex rule change. See Securities Exchange Act Release No. 50486 (October 4, 2004), 69 FR 60287 (October 8, 2004) (File No. S7-18-04). The \$305 per-hour figure for an attorney is from SIFMA'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. See Securities Exchange Act Release No. 59748 (April 10, 2009), 74 FR 18042, 18093 (April 20, 2009) (S7-08-09) (noting the Commission's modification to the \$305 per hour figure for an attorney).

report for expanding the scope of the consolidated audit trail would be approximately \$1,751,550 for a one-time cost of \$116,770 per SRO.<sup>375</sup>

Does this estimate accurately reflect the expenses, including SRO staff time and systems analyses, which SROs would incur in preparing the required report? Are there other costs components that should be considered in determining costs associated with preparing the required report? Please provide details on any additional costs that should be considered.

#### 8. Other Costs

Proposed Rule 613 would specifically require, for the receipt or origination of each order, information to be reported to the central repository with respect to the ultimate customer that generates the order. Specifically, members would be required to report to the central repository information about the beneficial owner of the account originating the order and the person exercising investment discretion for the account originating the order, if different from the beneficial owner, and each customer would be identified by a unique customer identifier. Thus, information about "live" orders, as well as overall order and execution information for a particular customer, would be available in the central repository. In recognition of the sensitivity of this data, the proposed Rule requires the NMS Plan to include policies and procedures, including standards, to be used by the plan processor to ensure the security and confidentiality of all information submitted to, and maintained by, the central repository.

However, a potential cost could be incurred if the security and confidentiality of the information submitted to the central repository is breached, either by malfeasance or accident. In

<sup>375</sup> Commission staff estimates that each member would expend (200 Attorney hours x \$305 per hour) + (50 Compliance Manager hours x \$258 per hour) + (110 Programmer Analyst hours x \$193 per hour) + (60 Business Analyst hours x \$194 per hour) + (25 Outsourced Legal Counsel hours x \$400 per hour) = \$116,770 to create and file with the Commission a report for expanding the scope of the consolidated audit trail. See *supra* Section V.D.1.b and note 302.

either case, if identifying information about customers and their trading is made public -- contrary to the expectations and intentions of the customers -- the Commission preliminarily believes that this may have a negative effect on the securities markets. Specifically, investors may be less willing to allocate their capital to the securities markets if their expectation that their personal identifying and trading information will be adequately protected by the central repository is not met. Under these circumstances, there could be a reduction in the capital invested in the markets for NMS securities by investors, to the detriment of the U.S. securities markets overall.

Proposed Rule 613 also would require that the NMS plan include policies and procedures, including standards, for the plan processor to use to ensure the integrity of the information submitted to the central repository. Specifically, the proposed Rule requires that the policies and procedures be designed to ensure the timeliness, accuracy, and completeness of the data provided to the central repository by the exchanges, FINRA and their members, and to require the rejection of data provided if the data does not meet validation parameters, and the retransmission of such data. The Commission notes that, despite such safeguards for ensuring the integrity of the audit trail data, the information submitted by the exchanges, FINRA and their members could be inaccurate, either due to system or human error. If the reliability of the data is compromised, this could reduce the usefulness of the consolidated audit trail data for regulatory purposes.

Are there any other non-tangible costs associated with potential breaches of the integrity or confidentiality of the data required to be submitted to the central repository that the Commission should consider?

#### **9. Total Costs**

Based on the assumptions and resulting estimated costs discussed above, the Commission preliminarily estimates the initial aggregate cost the exchanges and FINRA would incur to comply with the proposed Rule, other than costs related to creating and operating the central repository, would be approximately \$231 million,<sup>376</sup> and ongoing aggregate annual costs would be approximately \$77.7 million.<sup>377</sup> In addition, the exchanges and FINRA would incur an initial aggregate cost of approximately \$120 million to set up the central repository,<sup>378</sup> with ongoing annual costs to operate the central repository of approximately \$101 million.<sup>379</sup> For SRO members that would make changes to their own order management and trading systems to comply with the proposed Rule,<sup>380</sup> we estimate the initial aggregate one-time cost for

<sup>376</sup> This aggregate cost estimate includes the aggregate one-time cost of preparing and filing the NMS plan (\$3,503,100); the aggregate average one-time cost for each exchange and FINRA to synchronize clocks consistent with the proposed requirements (\$144,750); the aggregate average one-time cost for each exchange and FINRA to identify, collect and transmit the consolidated audit trail information to the central repository (\$75 million); the aggregate average one-time cost for each exchange and FINRA to develop and implement surveillance systems, or enhance existing surveillance systems (\$150 million); the aggregate one-time cost for each exchange and FINRA to file proposed rule changes to implement the provisions of the NMS plan with respect to their members (\$590,175); and the aggregate one-time cost to the exchanges and FINRA of jointly providing to the Commission a report outlining how the exchanges and FINRA would expand the scope of the consolidated audit trail (\$1,751,550).

<sup>377</sup> This aggregate cost estimate includes the aggregate average ongoing annual cost to ensure that the plan is up to date and remains in compliance with the proposed Rule (\$725,760); the aggregate average ongoing annual cost to synchronize clocks consistent with industry standards (\$173,700); the aggregate average ongoing annual cost to evaluate the synchronization standards (\$92,880); the aggregate average ongoing annual cost to ensure that each exchange and FINRA is providing information in compliance with the proposed Rule (\$37.5 million); and the aggregate average ongoing annual cost associated with enhanced surveillance (\$39,159,000).

<sup>378</sup> See supra note 368.

<sup>379</sup> See supra notes 369 to 371 and accompanying text.

<sup>380</sup> We preliminarily estimate there are 1,114 of these broker-dealers, including all clearing firms and alternative trading systems. See supra note 320.

implementation of the proposed Rule would be approximately \$3.4 billion<sup>381</sup> and aggregate ongoing annual costs would be approximately \$1.7 billion.<sup>382</sup> For SRO members that are likely to rely on a third party to comply with the proposed Rule (such as their clearing broker),<sup>383</sup> we estimate the initial aggregate one-time cost for implementation of the proposed Rule would be approximately \$287 million<sup>384</sup> and ongoing annual costs would be approximately \$253 million.<sup>385</sup> Therefore, for all SROs and members, we estimate that the total one-time aggregate cost to implement the proposed Rule would be approximately \$4 billion and the total ongoing aggregate annual costs would be approximately \$2.1 billion.

### C. Request for Comment

The Commission requests general comment on the costs and benefits of proposed Rule 613 of Regulation NMS discussed above, as well as any costs and benefits not already described

<sup>381</sup> This aggregate cost estimate includes the aggregate average one-time cost for such members to identify, collect and transmit the consolidated audit trail information to the central repository (\$3,342,000,000); and the aggregate average initial cost for such members to synchronize clocks consistent with the proposed requirements (\$10,750,100).

<sup>382</sup> This aggregate cost estimate includes the aggregate average ongoing annual cost for such members to identify, collect and transmit the consolidated audit trail information to the central repository (\$1,671,000,000); and the aggregate average ongoing annual cost for such members to annually evaluate the synchronization time standards and perform any necessary synchronization adjustments (\$19,798,008).

<sup>383</sup> We preliminarily estimate there are 3,006 of these broker-dealers, mainly including non-clearing broker-dealers. See supra note 327.

<sup>384</sup> This aggregate cost estimate includes the aggregate average initial cost for such members to identify, collect and transmit the consolidated audit trail information to the central repository (\$258,125,220); and the aggregate average initial cost for such members to synchronize clocks consistent with the proposed requirements (\$29,007,900).

<sup>385</sup> This aggregate cost estimate includes the aggregate average ongoing annual cost for such members to identify, collect and transmit the consolidated audit trail information to the central repository (\$199,935,072); and the aggregate average ongoing annual cost for such members to annually evaluate the synchronization time standards and perform any necessary synchronization adjustments (\$53,422,632).

which could result from the proposed Rule. The Commission also requests data to quantify any potential costs or benefits.

The Commission requests comment on what, if any, would be the impact of the proposed Rule on competition among the exchanges and other non-exchange market centers? If commenters believe there would be an impact on competition, please explain and quantify the costs or benefits of such impact. If commenters believe that there would be a cost, what steps could the Commission take to mitigate such costs?

The Commission also requests comment on whether the requirements of the proposed Rule, such as the requirement to provide detailed information to the central repository on a real time basis, would have an impact on any form of legal trading activity engaged in by market participants, or the speed with which trading occurs. For example, would requiring additional information to be attached to an order when the order is routed from one member or exchange to another - such as the unique order identifier - impact the speed with which routing and trading occurs? If not, why not? If so, why? If there would be an impact, do commenters believe that the impact would be negative? Why or why not? Also, would the requirement to provide customer and order information to the central repository in real time impact market participant trading activity? If so, how so? If commenters believe the impact would provide a benefit, please explain and quantify. If commenters believe that the impact would impose a cost, please explain and quantify. For example, would market participants be hesitant to engage in certain legal trading activity because of a concern about providing customer and order information in real time? Would market participants shift their trading activity to products or markets that do not require the capture of customer information to avoid compliance with this requirement of the proposed Rule? If so, how should the Commission address those concerns? Please be specific in

your responses. The Commission requests comment on any other changes to behavior that commenters believe may result from application of the proposed Rule. For example, do commenters believe that the proposal would cause illegal trading activity to shift to products or markets not covered by the proposed Rule? If so, should that impact the scope of the proposed Rule? If so, how so? If not, why not?

## **VII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation**

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and is 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 would promote efficiency, competition, and capital formation.<sup>386</sup> In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.<sup>387</sup> Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. As discussed below, the Commission's preliminary view is that the proposed Rule should promote efficiency, competition, and capital formation.

Section 11A(a)(3)(B) of the Exchange Act provides in part that the Commission may, by rule, require SROs to act jointly with respect to matters as to which they share authority under the Exchange Act in regulating a national market system for securities.<sup>388</sup> Proposed Rule 613 would require all national securities exchanges and national securities associations to jointly

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<sup>386</sup> 15 U.S.C. 78c(f).

<sup>387</sup> 15 U.S.C. 78w(a)(2).

<sup>388</sup> See Section 11A(a)(3)(B) of the Exchange Act, 15 U.S.C. 78k-1(a)(3)(B).

submit to the Commission an NMS plan to create, implement, and maintain a consolidated audit trail for NMS securities. Under the proposal, pursuant to the NMS plan, and SRO rules adopted thereunder to implement the plan, national securities exchanges and national securities associations, as well as their members, would be required to provide detailed order and execution data to a central repository to populate a consolidated audit trail.<sup>389</sup>

#### A. Competition

The Commission considered the impact of proposed Rule 613 on the national securities exchanges, national securities associations, and their members that trade NMS securities. The Commission begins its consideration of potential competitive impacts with observations of the current structure of the markets for trading NMS securities.

The industry for the trading of NMS securities is a competitive one, with reasonably low barriers to entry and significant competition for order flow. The intensity of competition across trading platforms that trade NMS securities has increased dramatically in the past decade as a result of technological advances and regulatory changes. This increase in competition has resulted in decreases in market concentration, more competition among market centers, a proliferation of trading platforms competing for order flow, and decreases in trading fees.

In addition, the Commission, within the past five years, has approved applications by BATS,<sup>390</sup> Direct Edge,<sup>391</sup> Nasdaq,<sup>392</sup> and C2<sup>393</sup> to become registered as national securities

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<sup>389</sup> See *supra* Section III.D. for a detailed description of the required data.

<sup>390</sup> See Securities Exchange Act Release No. 58375 (August 18, 2008), 73 FR 49498 (August 21, 2008) (order approving BATS Exchange's application for registration as a national securities exchange).

<sup>391</sup> See Securities Exchange Act Release No. 61698 (March 12, 2010), 75 FR 13151 (March 18, 2010) (order approving EDGA Exchange and EDGX Exchange's applications for registration as national securities exchanges).



exchanges for trading equities, approved proposed rule changes by two existing exchanges – the ISE<sup>394</sup> and CBOE<sup>395</sup> - to add cash equity trading facilities to their existing options business; and approved proposed rule changes by two existing exchanges – Nasdaq and BATS – to add options trading facilities to their existing cash equities business.<sup>396</sup>

The Commission believes that competition among trading venues for NMS stocks has been facilitated by several Commission rules: Rule 611 (the Order Protection Rule), which encourages quote-based competition between market centers; Rule 605, which empowers investors and brokers to compare execution quality statistics across trading venues; and Rule 606, which enables customers to monitor the order routing practices. Similarly, there is rigorous competition among the options exchanges that has been facilitated by regulatory efforts. These include the move to multiple listing,<sup>397</sup> the extension of the Commission's Quote Rule to options,<sup>398</sup> the prohibition against trading outside of the national best bid and offer,<sup>399</sup> the

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<sup>392</sup> See Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131) (order approving Nasdaq's application for registration as a national securities exchange).

<sup>393</sup> See Securities Exchange Act Release No. 61152 (December 10, 2009), 74 FR 66699 (December 16, 2009) (order approving C2 Options Exchange's application for registration as a national securities exchange).

<sup>394</sup> See Securities Exchange Act Release No. 54528 (September 28, 2006), 71 FR 58650 (October 4, 2006) (order approving rules to govern trading equities).

<sup>395</sup> See Securities Exchange Act Release No. 55389 (March 2, 2007), 72 FR 10575 (March 8, 2007) (order approving CBOE Stock Exchange LLC as a facility of CBOE).

<sup>396</sup> See Securities Exchange Act Release Nos. 57478 (March 12, 2008), 73 FR 14321 (March 18, 2008) (order approving rules governing the trading of options on the Nasdaq Options Market, LLC); and 61419 (January 26, 2010), 75 FR 5157 (February 1, 2010) (order approving rules governing the trading of options on BATS Options Exchange, Inc.).

<sup>397</sup> See Securities Exchange Act Release No. 26870 (May 26, 1989), 54 FR 23963 (June 5, 1989) (S7-25-87).

<sup>398</sup> See Securities Exchange Act Release No. 43591 (November 17, 2000), 65 FR 75439 (December 1, 2000).

adoption of market structures on the floor-based exchanges that permit individual market maker quotations to be reflected in the exchange's quotation,<sup>400</sup> and the Minimum Quoting Increment Pilot Program.<sup>401</sup>

The broker-dealer industry also is a highly competitive industry with low barriers to entry. Most trading activity is concentrated among several dozen large participants, with thousands of small participants competing for niche or regional segments of the market. The reasonably low barriers to entry for broker-dealers are evidenced, for example, by the fact that the average number of new broker-dealers entering the market each year between 2001 and 2008 was 389.<sup>402</sup>

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<sup>399</sup> See Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (approved of Options Order Protection and Locked/Crossed Market Plan).

<sup>400</sup> See, e.g., Securities Exchange Act Release No. 47959 (May 30, 2003), 68 FR 34441, 34442 (June 9, 2003) (SR-CBOE-2002-05) (adopting, among other things, amendments to incorporate firm quote requirements in CBOE's rules).

<sup>401</sup> On January 26, 2007, the then-existing six options exchanges implemented a pilot program to quote certain options series in thirteen classes in one-cent increments ("Minimum Quoting Increment Pilot Program"). Nasdaq became a participant in the Minimum Quoting Increment Pilot Program on March 31, 2008, when it commenced trading on its options platform, and BATS became a participant in the Pilot Program on February 26, 2010, when it commenced trading on BATS Options. Since 2007, the Minimum Quoting Increment Pilot Program has been extended and expanded several times. See, e.g., Securities Exchange Act Release Nos. 56276 (August 17, 2007), 72 FR 47096 (August 22, 2007) (SR-CBOE-2007-98); 56567 (September 27, 2007), 72 FR 56396 (October 3, 2007) (SR-Amex-2007-96); 57579 (March 28, 2008), 73 FR 18587 (April 4, 2008) (SR-Nasdaq-2008-026); 60711 (September 23, 2009), 74 FR 49419 (September 28, 2009) (SR-NYSEArca-2009-44); and 61061 (November 24, 2009), 74 FR 62857 (December 1, 2009) (SR-NYSEArca-2004-44).

<sup>402</sup> This number is based on a Commission staff review of FOCUS Report filings reflecting registered broker-dealers from 2001 through 2008. The number does not include broker-dealers that are delinquent on FOCUS Report filings. New registered broker-dealers for each year during the period from 2001 through 2008 were identified by comparing the unique registration number of each broker-dealer filed for the relevant year to the registration numbers filed for each year between 1995 and the relevant year.

There are approximately 5,178 registered broker-dealers, of which approximately 890 are small broker-dealers.<sup>403</sup> To limit costs and make business more viable, the small participants often contract with bigger participants to handle certain functions, such as clearing and execution, or to update their technology. Larger broker-dealers often enjoy economies of scale over smaller broker-dealers and compete with each other to service the smaller broker-dealers, who are both their competitors and customers.

In the Commission's preliminary judgment, the costs of proposed Rule 613 would not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. In industries characterized by easy entry and intense competition, the viability of some of the competitors may be sensitive to regulatory costs. Nonetheless, the Commission preliminarily believes that the overall marketplace for NMS securities would remain highly competitive, despite the costs associated with implementing proposed new Rule 613, even if those costs influence the entry or exit decisions of some individual broker-dealer firms.

As discussed above in Sections V and VI, the Commission acknowledges that the proposal would entail significant costs of implementation. In particular, requiring national securities exchanges, national securities associations, and their members to capture the required information and provide it to the central repository in a uniform format, in particular information that is not currently captured under the existing audit trail or other regulatory requirements, would likely require significant one-time initial expenses to enhance or modify existing order handling, trading, and other systems. In addition, national securities exchanges and national

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<sup>403</sup> These numbers are based on a review of 2007 and 2008 FOCUS Report filings reflecting registered broker-dealers, and discussions with SRO staff. The number does not include broker-dealers that are delinquent on FOCUS Report filings.

securities associations would need to enhance or create new surveillance procedures to use the consolidated audit trail information. Preliminarily, the Commission does not believe that these implementation expenses would impose an undue burden on competition among SROs or among other market participants. The Commission preliminarily believes that the requirements associated with the proposed Rule are necessary and appropriate, and would apply uniformly to all national securities exchanges, national securities associations and their members, and thus would not result in an undue burden on competition.

As discussed above in Section II, the approach of proposed new Rule 613 would advance the purposes of the Exchange Act in a number of significant ways. The Commission preliminarily believes that proposed Rule 613 should aid each of the exchanges and FINRA in carrying out its statutory obligation to be organized and have the capacity to comply, and enforce compliance by its members, with its rules, and with the federal securities laws, rules, and regulations. Likewise, the Commission believes that proposed Rule 613 should aid the Commission in fulfilling its statutory obligation to oversee the exchanges and associations, and to enforce compliance by the members of exchanges and associations with the respective exchange's or association's rules, and the federal securities laws and regulations. The proposed consolidated audit trail also would aid the Commission in its efforts to limit the manipulation of security prices, and to limit the use of manipulative or deceptive devices in the purchase or sale of a security. By potentially decreasing the opportunities for illegal activity and market manipulation, the proposed Rule should promote fair competition among market participants on the basis of effective regulation. Further, by imposing uniform audit trail requirements on all SROs and their members, and thus removing any incentive to compete based on regulation (or lack thereof), Commission preliminarily believes that the proposed Rule would allow SROs and

their members to more effectively compete on other terms such as the services provided, price, and available liquidity.

Based on the analysis above, the Commission preliminarily believes that the proposal would not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. However, we seek comment on the impact of the proposed Rule on competition. The Commission requests comment on what, if any, would be the impact of the proposed Rule on competition among the exchanges and other non-exchange market centers? If commenters believe there would be an impact on competition, please explain and quantify the costs or benefits of such impact. For example, as noted above, exchanges would have access through the central repository to trading information about their competitors' customers. Do commenters believe that access to this information would have an impact on competition among exchanges? If so, please explain what the potential impact could be, and whether you believe that such impact would be an adverse. If so, please further address what, if any, steps the Commission should take in the proposed Rule to address such concerns.

#### **B. Capital Formation**

As discussed above in Section II, proposed Rule 613 is intended to enhance the ability of the SROs and the Commission to more efficiently and in a more timely manner monitor trading in NMS securities across all markets and market participants, which should further the ability of the SROs and the Commission staff to effectively enforce SRO rules and federal securities laws, rules and regulations. For example, the proposed consolidated audit trail would ensure that all orders are tracked from origination to execution or cancellation. Further, the consolidated audit trail would provide information on any modifications or routing decisions made with regard to an order. The Commission preliminarily believes that the proposed audit trail information would

greatly enhance the ability of its staff to effectively monitor and surveil the securities markets. This enhanced ability of the SROs and Commission staff to enforce the federal securities laws, rules, and regulations should help ensure that market participants that engage in fraudulent or manipulative activities are identified more swiftly, which should deter future attempts to do the same. In general, the faster fraudulent or manipulative activity is identified and action is taken, the more likely ill-gotten gains will remain available to pay penalties or compensate victims.

The Commission preliminarily believes that by enhancing the SROs' and the Commission's ability to enforce the federal securities laws, rules and regulations, proposed Rule 613 could help maintain or increase investor confidence in the fairness of the securities markets. Investor confidence may increase as the potential for the detection of illegal activity is increased and the risk of investment loss due to undetected illegal activity decreases. Bolstering investor confidence in the fairness of the securities markets may increase the level of investment, which could promote capital formation to the extent that the increase is allocated efficiently. This would promote capital formation because as capital is better allocated, issuers with the most productive capital needs may be better able to raise capital.

### C. Efficiency

Proposed Rule 613 would require the creation and maintenance of a consolidated audit trail, which the Commission preliminarily believes would greatly enhance the ability of SRO staff to effectively monitor and surveil the securities markets, and thus detect illegal activity in a more timely manner, whether on one market or across markets. With an audit trail designed to help the SROs reconstruct and analyze time-sequenced order and trading data, the SROs could more quickly investigate the nature and causes of unusual market movements or trading activity and initiate investigations and take regulatory actions where warranted. An increase in detected

and prosecuted violations of the securities laws, rules, and regulations would likely act as deterrent to future violations. Likewise, the ability of the Commission to better understand unusual market activity, such as during a period of intense volatility, could lead to better oversight, or more focused regulation where warranted, of the causes of such activity. For example, the possibility of more prompt detection of illegal activity would likely deter future abusive or manipulative trading activity from being used to manipulate market prices to artificial levels or by accelerating a declining market in one or several securities. Thus, the Commission preliminarily believes that proposed Rule 613 would help to ensure that markets function efficiently. As a result, the Commission preliminarily believes that the proposed consolidated audit trail would help promote the efficient functioning of markets, which should help enhance the protection of investors and further the public interest.

Further, the Commission preliminarily believes that the proposed Rule, by creating one central repository to which each national securities exchange, national securities association, and their members would be required to provide the same data in the same format, could reduce or eliminate the need for each individual SRO to have its own disparate requirements. Elimination of often inconsistent regulation on members would promote efficiency because members would no longer be required to submit disparate data to multiple regulators pursuant to multiple, and sometimes inconsistent, SRO and Commission rules.

The Commission requests comment on all aspects of this analysis and, in particular, on whether the proposed consolidated audit trail would place a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act, as well as the effect of the proposal on efficiency, competition, and capital formation. The Commission also requests comment on the impact, if any, of the proposed Rule on investors' trading activities. Would the

proposed Rule impact investors' incentives to engage in certain types of legal trading in NMS securities, or other products, on the exchanges or OTC markets that would be subject to the proposed Rule? If so, why, and what impact would that have on the competitiveness of the U.S. markets? Would the proposed Rule impact market participants' incentives to engage in certain types of illegal trading activity in products other than NMS securities or in other markets? If so, how so, and what if any steps should the Commission take to address the expected changes in behavior? Commenters are requested to provide empirical data and other factual support for their views.

#### **VIII. Consideration of Impact on the Economy**

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"<sup>404</sup> the Commission must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (1) an annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation.

The Commission requests comment on the potential impact of proposed Rule 613 on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

#### **IX. Initial Regulatory Flexibility Act Analysis**

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<sup>404</sup> Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).



The Regulatory Flexibility Act ("RFA")<sup>405</sup> requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)<sup>406</sup> of the Administrative Procedure Act,<sup>407</sup> as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on "small entities."<sup>408</sup>

Proposed Rule 613 of Regulation NMS would require the national securities exchanges and national securities associations to jointly develop and file with the Commission a NMS plan to implement and maintain a consolidated audit trail. Pursuant to such NMS plan, and rules that would be adopted by the SROs to implement the plan, national securities exchanges and national securities associations, as well as their members, would be required to provide data to a central repository to populate a consolidated audit trail.<sup>409</sup>

**A. Reasons for the Proposed Rule**

The Commission preliminarily believes that with today's electronic, interconnected markets, there is a heightened need for regulators to have efficient access to a more robust and effective cross-market order and execution tracking system. As discussed above, currently many of the national securities exchanges and FINRA have audit trail rules and systems to track information relating to orders received and executed, or otherwise handled, in their respective

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<sup>405</sup> 5 U.S.C. 601 et seq.

<sup>406</sup> 5 U.S.C. 603(a).

<sup>407</sup> 5 U.S.C. 551 et seq.

<sup>408</sup> The Commission has adopted definitions for the term small entity for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0-10, 17 CFR 240.0-10. See Securities Exchange Act Release No. 18451 (January 28, 1982), 47 FR 5215 (February 4, 1982) (File No. AS-305).

<sup>409</sup> See proposed Rule 613(c) and supra Sections III.B. and III.D.

markets. While the information gathered from these audit trail systems aids the SRO and Commission staff in their regulatory responsibility to surveil for compliance with SRO rules and the federal securities laws and regulations, the Commission preliminarily believes that existing audit trails are limited in their scope and effectiveness in varying ways.<sup>410</sup> In addition, while the SRO and Commission staff also currently receives information about orders and/or trades through the EBS system, Rule 17a-25,<sup>411</sup> and from equity cleared reports, the information is limited, to varying degrees, in detail and scope.<sup>412</sup>

The creation and implementation of a consolidated audit trail, as proposed, would enable regulators to better fulfill their regulatory responsibilities to monitor for and investigate potentially illegal activity in the NMS for securities in a more timely fashion, whether on one market or across markets. A consolidated audit trail also would enhance the ability of the Commission in investigating and preparing market reconstructions, and in understanding the causes of unusual market activity. Further, timely pursuit of potential violations can be important in seeking to freeze and recover any profits received from illegal activity.

#### **B. Objectives and Legal Basis**

Each national securities exchange and national securities association must be organized and have the capacity to comply, and enforce compliance by its members, with its rules, and with the federal securities laws, rules, and regulations.<sup>413</sup> Likewise, the Commission oversees the

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<sup>410</sup> See supra Section II.A.

<sup>411</sup> 17 CFR 240.17a-25.

<sup>412</sup> See supra Sections I.A and I.B. for a description of the EBS system, Rule 17a-25, and equity cleared reports.

<sup>413</sup> See, e.g., Sections 6(b)(1), 19(g)(1) and 15A(b)(2) of the Exchange Act, 15 U.S.C. 78(f)(b)(1), 78s(g)(1), and 78o-3(b)(2).

exchanges and associations,<sup>414</sup> and enforces compliance by the members of exchanges and associations with the respective exchange's or association's rules, and the federal securities laws and regulations.<sup>415</sup> The Commission preliminarily believes that the exchanges, FINRA and the Commission itself could more effectively and efficiently fulfill these statutory obligations to oversee and regulate the NMS if the SROs and the Commission had direct access to more robust, and timely, order and execution information across all markets.

The Commission is proposing Rule 613 under the authority set forth in Exchange Act Sections 2, 3(b), 5, 6, 11, 11A, 15, 15A, 17(a) and (b), 19, 23(a), and 36 thereof, 15 U.S.C. 78b, 78c(b), 78e, 78f, 78k-1, 78o, 78o-3, 78q(a) and (b), 78s, 78w(a), and 78mm.

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

**1. National Securities Exchanges and National Securities Associations**

The proposed Rule would apply to national securities exchanges registered with the Commission under Section 6 of the Exchange Act and national securities associations registered with the Commission under Section 15A of the Exchange Act. None of the national securities exchanges registered under Section 6 of the Exchange Act or national securities associations registered with the Commission under Section 15A of the Exchange Act that would be subject to the proposed Rule are "small entities" for purposes of the RFA.<sup>416</sup>

<sup>414</sup> See, e.g., Sections 2, 6(b), 15A(b), and 19(h)(1) of the Exchange Act, 15 U.S.C. 78(b), 15 U.S.C. 78(f)(6), 15 U.S.C. 78o-3(b), and 15 U.S.C. 78(h)(1).

<sup>415</sup> See, e.g., 19(h)(1) of the Exchange Act, 15 U.S.C. 78(h)(1).

<sup>416</sup> See 17 CFR 240.0-10(e). Paragraph (e) of Rule 0-10 states that the term "small business," when referring to an exchange, means any exchange that has been exempted from the reporting requirements of Rule 601 of Regulation NMS, 17 CFR 242.601, and is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in Rule 0-10. Under this standard, none of the exchanges subject to the proposed Rule is a "small entity" for the purposes of the RFA. FINRA is not a small entity as defined by 13 CFR 121.201.

## 2. Broker-Dealers

Proposed Rule 613(g) would apply to all broker-dealers that are members of a national securities exchange or national securities association. Commission rules generally define a broker-dealer as a small entity for purposes of the Exchange Act and the Regulatory Flexibility Act if the broker-dealer had a total capital of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, and it is not affiliated with any person (other than a natural person that is not a small entity).<sup>417</sup>

The Commission estimates that as of December 31, 2008, there were approximately 890 Commission-registered broker-dealers that would be considered small entities for purposes of the statute. Each of these brokers-dealers, assuming that they are all members of one or more national securities exchange or FINRA, would be required to comply with the proposed Rule.

### D. Reporting, Record Keeping, and Other Compliance Requirements

Proposed Rule 613(g)(2) would impose new reporting and record keeping requirements on small broker-dealers. While certain elements of order and execution information that such small broker-dealers would be required to collect and submit to the central repository are already required to be maintained by broker-dealers pursuant to Rules 17a-3 and 17a-25 under the Exchange Act or the SRO audit trail rules, the proposed Rule would require the collection of additional information that is not required to be collected under these rules. Further, small broker-dealers would be responsible for complying with the proposed Rule's requirements for reporting to the central repository the required order and transaction data.

The proposed Rule would require that most of the information collected be reported on a real time basis, rather than on an "as requested" basis, and that all required information be

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<sup>417</sup> See 17 CFR 240.0-10(c).

submitted in a uniform format. Accordingly, the Commission preliminarily believes that even those small broker-dealers that already have systems in place for submitting order and transaction information to regulators upon request, or to comply with existing SRO audit trail rules, would need to make modifications to their existing order handling and trading systems to comply with the proposed Rule, or rely on outside vendors to provide a functionality that would provide information to the central repository.

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

As stated above, broker-dealers are subject to record keeping and reporting requirements under Rules 17a-3 and 17a-25 under the Exchange Act. Rule 17a-3 requires that broker-dealers maintain records that would capture some of the same information required to be collected and submitted pursuant to the proposed Rule.<sup>418</sup> Also, as part of the Commission's existing EBS system, pursuant to Rule 17a-25 under the Exchange Act, the Commission requires registered broker-dealers to keep records of some of the information that would be captured by proposed Rule 613.<sup>419</sup>

However, data collected pursuant to Rules 17a-3 and 17a-25 is limited in scope and is provided to the Commission only upon request. The proposed Rule would require the collection

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<sup>418</sup> See 17 CFR 240.17a-3. Pursuant to Rule 17a-3, broker-dealers are, for example, required to maintain the following information that would be captured by the proposed rule: customer name and address; time an order was received; and price of execution.

<sup>419</sup> See 17 CFR 240.17a-25. Pursuant to Rule 17a-25, broker-dealers are, for example, required to maintain the following information with respect to customer orders that would be captured by the proposed Rule, and provide it to the Commission upon request: date on which the transaction was executed; account number; identifying symbol assigned to the security; transaction price; the number of shares or option contracts traded and whether such transaction was a purchase, sale, or short sale, and if an option transaction, whether such was a call or put option; the clearing house number of such broker or dealer and the clearing house numbers of the brokers or dealers on the opposite side of the transaction; prime broker identifier; the customer's name and address; the customer's tax identification number; and other related account information.

of significantly more information<sup>420</sup> and would require that most of the information about orders and executions be provided to the central repository on a real time basis, not merely be stored and provided upon request. Thus, the Commission preliminarily believes that while these Federal rules overlap with certain requirements of the proposed Rule, the scope and purpose of the proposed Rule is more expansive than what is currently required and will more efficiently provide regulators with the information needed to effectively surveil trading activity across markets.

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

Pursuant to 3(a) of the RFA, the Commission must consider the following types of alternatives: (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) clarification, consolidation, or simplification of compliance and reporting requirements under the Rule for small entities; (3) the use of performance rather than design standards; and (4) and exemption from coverage of the proposed Rule, or any part thereof, for small entities.

The Commission has considered whether it would more be more cost effective to enhance existing systems to achieve the proposed Rule's objective, rather than create a central repository. For example, the Commission considered expanding the scope of the information

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<sup>420</sup> Such additional information would include: a unique customer identifier for each customer; a unique identifier that would attach to the order at the time the order is received or originated by the member and remain with the order through the process of routing, modification, cancellation, and execution (in whole or in part); a unique identifier of the broker-dealer receiving or originating the order; the unique identifier of the branch office and registered representative receiving or originating the order; the date on which the order is routed; time at which the order is routed (in milliseconds); and if the order is executed, in whole or in part, the account number for any subaccounts to which the execution is allocated; the unique order identifier of any contra-side order(s); and the amount of a commission, if any, paid by the customer, and the unique identifier of the broker-dealer(s) to whom the commission is paid.

collected by existing audit trails, the EBS system, and/or Rule 17a-25, but determined that this approach would not result in the creation of a comprehensive consolidated audit trail. Under such an approach, SROs would still need to check multiple repositories of data to gather information about trading activity occurring across markets. Further, the goal of capturing data in a uniform format would be complicated if data were collected by multiple repositories. In addition, this approach would not resolve concerns over how long it takes to obtain data when it is not available in real time, but only required to be provided upon request. Without the centralization of data in a uniform electronic format, the Commission preliminarily believes that the goals of the proposed Rule could not be achieved.

The Commission preliminarily believes that proposing a new uniform audit trail rule that would apply equally across all SROs and their members would be more efficient and effective than requiring each SRO to separately amend and enhance its existing order audit trail or EBS rules and systems, and amending Rule 17a-25. The scope of the proposed audit trail – requiring each member and SRO to report the same information for each order, for each reportable event, in a uniform format, in real time, across all markets – is fundamentally different than what is collected under existing order audit trails, the EBS system, and Rule 17a-25.

The Commission also has considered allowing certain small broker-dealers to submit certain trading data in a manual, rather than an electronic, format.<sup>421</sup> However, the Commission preliminarily does not believe that the intent and objectives of proposed Rule 613 could be achieved if small broker-dealers are subject to differing compliance or reporting requirements, such as manual reporting of data, or timetables. The Commission preliminarily believes that to be effective the consolidated audit trail should contain order and execution information from all

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<sup>421</sup> See 17a-25 Adopting Release, *supra* note 20, at 35839–35840.

broker-dealers, including small broker-dealers, in a uniform electronic format. Without this information, the SROs and the Commission would not have a complete and timely cross-market audit trail to utilize in their regulatory oversight of small broker-dealers, their customers, and the securities markets. Further, the Commission preliminarily believes that the timetable contained in the proposed Rule, which would give brokers-dealers two years after effectiveness of the NMS plan to implement the proposed requirements to collect and report the required information to the central repository, would allow small broker-dealers sufficient time to modify existing systems, or procure third party functionality, to comply with the proposed Rule.<sup>422</sup>

Further, the Commission preliminarily believes that it has drafted the proposed Rule to be as straightforward as possible to achieve its objectives. Any simplification, consolidation or clarification of the Rule should occur for all entities, not just small broker-dealers. The Commission does not propose to dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed Rule. However, in order to provide consistent, comparable data to the central repository, the nature of the information collected is a design standard.

The Commission would be able to rely on its exemptive authority under Section 36 of the Exchange Act to grant relief, when necessary, to small broker-dealers from the requirements of the proposed Rule. The Commission preliminarily believes that a wholesale exemption from the proposed Rule for small broker-dealers, however, would make it harder for the Commission and SROs to recognize the anticipated benefits of the consolidated audit trail.

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

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<sup>422</sup> See supra notes 326-330 and accompanying text and notes 356-358 and accompanying text.



The Commission invites commenters to address whether the proposed Rule would have a significant economic impact on a substantial number of small entities, and, if so, what would be the nature of any impact on small entities. The Commission requests that commenters provide empirical data to support the extent of such impact.

#### **X. Statutory Authority**

Pursuant to the Exchange Act and particularly, Sections 2, 3(b), 5, 6, 11A, 15, 15A, 17(a) and (b), 19, and 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78e, 78f, 78k-1, 78o, 78o-3, 78q(a) and (b), 78s and 78w(a), the Commission proposes Rule 613 of Regulation NMS, as set forth below.

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

#### **List of Subjects in 17 CFR Part 242**

Brokers, Reporting and recordkeeping requirements, Securities.

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

#### **PART 242 — REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES**

1. The authority citation for part 242 continues to read as follows:

**Authority:** 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

2. Add § 242.613 to read as follows:

#### **§ 242.613 Consolidated Audit Trail.**

- (a) Creation of a National Market System Plan Governing a Consolidated Audit Trail.

- (1) Each national securities exchange and national securities association shall jointly file on or before [90 days from approval of this rule] a national market system plan to govern the

creation, implementation, and maintenance of a consolidated audit trail and central repository as required by this section.

(2) The national market system plan, or any amendment thereto, filed pursuant to this section shall be filed with the Commission pursuant to §242.608.

(3) The national market system plan submitted pursuant to this section shall require each national securities exchange and national securities association to:

(i) By two months after effectiveness of the national market system plan jointly (or under the governance structure described in the plan) select a person to be the plan processor;

(ii) By four months after effectiveness of the national market system plan synchronize their business clocks and by four months after effectiveness of the national market system plan require members of each such exchange and association to synchronize their business clocks in accordance with paragraph (d) of this section;

(iii) By one year after effectiveness of the national market system plan provide to the central repository the data specified in paragraph (c) of this section;

(iv) By fourteen months after effectiveness of the national market system plan implement a new or enhanced surveillance system(s) as required by paragraph (f) of this section; and

(v) By two years after effectiveness of the national market system plan require members of each such exchange and association to provide to the central repository the data specified in paragraph (c) of this section.

(4) Each national securities exchange and national securities association shall be a sponsor of the national market system plan submitted pursuant to this section and approved by the Commission.

(5) No national market system plan filed pursuant to this section, or any amendment thereto, shall become effective unless approved by the Commission or otherwise permitted in accordance with the procedures set forth in §242.608.

(b) Operation and Administration of the National Market System Plan.

(1) The national market system plan submitted pursuant to this section shall include a governance structure to ensure fair representation of the plan sponsors, and administration of the central repository, including the selection of the plan processor.

(2) The national market system plan submitted pursuant to this section shall include a provision addressing the requirements for the admission of new sponsors of the plan and the withdrawal of existing sponsors from the plan.

(3) The national market system plan submitted pursuant to this section shall include a provision addressing the percentage of votes required by the plan sponsors to effectuate amendments to the plan.

(4) The national market system plan submitted pursuant to this section shall include a provision addressing the manner in which the costs of operating the central repository will be allocated among the national securities exchanges and national securities associations that are sponsors of the plan, including a provision addressing the manner in which costs will be allocated to new sponsors to the plan.

(5) The national market system plan submitted pursuant to this section shall require the appointment of a Chief Compliance Officer to regularly review the operation of the central repository to assure its continued effectiveness in light of market and technological developments, and make any appropriate recommendations for enhancements to the nature of the information collected and the manner in which it is processed.

(c) Data Collection.

(1) The national market system plan submitted pursuant to this section shall provide for an accurate, time-sequenced record of orders beginning with the receipt or origination of an order by a member of a national securities exchange or national securities association, and further documenting the life of the order through the process of routing, modification, cancellation, and execution (in whole or in part) of the order.

(2) The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member to collect and provide to the central repository the information required by paragraph (c)(7) of this section in a uniform electronic format.

(3) The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member to collect and provide to the central repository the information required by paragraphs (c)(7)(i) through (v) of this section on a real time basis.

(4) The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member to collect and provide to the central repository the information required by paragraphs (c)(7)(vi) and (vii) of this section promptly after the national securities exchange, national securities association, or member receives the information, but in no instance later than midnight of the day that the reportable event occurred or the national securities exchange, national securities association, or member receives such information.

(5) The national market system plan submitted pursuant to this section shall require each national securities exchange and its members to collect and provide to the central repository

the information required by paragraph (c)(7) of this section for each NMS security registered or listed for trading on such exchange or admitted to unlisted trading privileges on such exchange.

(6) The national market system plan submitted pursuant to this section shall require each national securities association and its members to collect and provide to the central repository the information required by paragraph (c)(7) of this section for each NMS security for which transaction reports are required to be submitted to the association.

(7) The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and any member of such exchange or association to collect and electronically provide to a central repository details for each order and each reportable event, including, but not limited to, the following information:

(i) For the original receipt or origination of the order:

(A) Information of sufficient detail to identify the customer;

(B) A unique customer identifier for each customer;

(C) Customer account information;

(D) A unique identifier that will attach to the order at the time the order is received or originated by the member and remain with the order through the process of routing, modification, cancellation, and execution (in whole or in part);

(E) The unique identifier of the broker-dealer receiving or originating the order;

(F) The unique identifier of the branch office and registered representative receiving or originating the order;

(G) Date of order receipt or origination;

(H) Time of order receipt or origination (in milliseconds); and

(I) Material terms of the order.

(ii) For the routing of an order, the following information:

(A) The unique order identifier;

(B) Date on which the order is routed;

(C) Time at which the order is routed (in milliseconds);

(D) The unique identifier of the broker-dealer or national securities exchange routing

the order;

(E) The unique identifier of the broker-dealer or national securities exchange

receiving the order;

(F) If routed internally at the broker-dealer, the identity and nature of the department or desk to which an order is routed; and

(G) Material terms of the order.

(iii) For the receipt of an order, the following information:

(A) The unique order identifier;

(B) Date on which the order is received;

(C) Time at which the order is received (in milliseconds);

(D) The unique order identifier of the broker-dealer or national securities exchange

receiving the order;

(E) The unique identifier of the broker-dealer or national securities exchange routing

the order; and

(F) Material terms of the order.

(iv) If the order is modified or cancelled, the following information:

(A) Date the modification or cancellation is received or originated;

(B) Time the modification or cancellation is received or originated (in milliseconds);

- (C) Price and remaining size of the order, if modified;
- (D) Other changes in material terms of the order, if modified; and
- (E) Identity of the person giving the modification or cancellation instruction.
- (v) If the order is executed, in whole or in part, the following information:
  - (A) The unique order identifier;
  - (B) Date of execution;
  - (C) Time of execution (in milliseconds);
  - (D) Execution capacity (principal, agency, riskless principal);
  - (E) Execution price and size;
  - (F) The unique identifier of the national securities exchange or broker-dealer

executing the order; and

(G) Whether the execution was reported pursuant to an effective transaction reporting plan or the Options Price Reporting Authority Plan.

(vi) If the order is executed, in whole or in part:

(A) The account number for any subaccounts to which the execution is allocated (in whole or part);

(B) The unique identifier of the clearing broker or prime broker, if applicable;

(C) The unique order identifier of any contra-side order(s);

(D) Special settlement terms, if applicable;

(E) Short sale borrow information and identifier; and

(F) The amount of a commission, if any, paid by the customer, and the unique identifier of the broker-dealer(s) to whom the commission is paid.

(vii) If the execution is cancelled, a cancelled trade indicator.

(8) All plan sponsors and their members shall use the same unique customer identifier and unique broker-dealer identifier for each customer and broker-dealer.

(d) Clock Synchronization. The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member of such exchange or association subject to this section to:

(1) Synchronize on its business clocks that are used for the purposes of recording the date and time of any reportable event that must be reported pursuant to this section to the time maintained by the National Institute of Standards and Technology, consistent with industry standards; and

(2) Evaluate annually the synchronization standard to determine whether it should be shortened, consistent with changes in industry standards.

(e) Central Repository.

(1) The national market system plan submitted pursuant to this section shall provide for the creation and maintenance of a central repository. Such central repository shall be responsible for the receipt, consolidation, and retention of all data submitted pursuant to this section.

(2) Each national securities exchange, national securities association, and the Commission shall have access to the central repository, including all systems operated by the central repository, and access to and use of the data reported to and consolidated by the central repository under paragraph (c) of this section, for the purpose of performing its respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations. The national market system plan submitted pursuant to this section shall provide that such access to and use of such data by each national securities exchange, national securities



association, and the Commission for the purpose of performing its regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations shall not be limited.

(3) The national market system plan submitted pursuant to this section shall include a provision requiring the creation and maintenance by the central repository of a method of access to the consolidated data that includes search and reporting functions.

(4) The national market system plan submitted pursuant to this section shall include policies and procedures, including standards, to be used by the plan processor to:

(i) Ensure the security and confidentiality of all information submitted to the central repository. All plan sponsors and their employees, as well as all employees of the central repository, shall agree to use appropriate safeguards to ensure the confidentiality of such data and shall agree not to use such data for any purpose other than surveillance and regulatory purposes. Nothing in this paragraph (i) shall be construed to prevent a plan sponsor from using the data that it submits to the central repository for regulatory, surveillance, commercial, or other purposes as otherwise permitted by applicable law, rule, or regulation;

(ii) Ensure the timeliness, accuracy, and completeness of the data provided to the central repository pursuant to paragraph (c) of this section;

(iii) Require the rejection of data provided to the central repository pursuant to paragraph (c) of this section that does not meet these validation parameters and the retransmission of corrected data; and

(iv) Ensure the accuracy of the consolidation by the plan processor of the data provided to the central repository pursuant to paragraph (c) of this section.

(5) The national market system plan submitted pursuant to this section shall require the central repository to collect and retain on a current and continuing basis and in a format compatible with the information collected pursuant to paragraph (c)(7) of this section;

(i) The national best bid and national best offer for each NMS security;

(ii) Transaction reports reported pursuant to an effective transaction reporting plan filed with the Commission pursuant to, and meeting the requirements of, §242.601; and

(iii) Last sale reports reported pursuant to the Options Price Reporting Authority Plan filed with the Commission pursuant to, and meeting the requirements of, §242.608.

(6) The national market system plan submitted pursuant to this section shall require the central repository to retain the information collected pursuant to paragraphs (c)(7) and (e)(5) of this section in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years. The information shall be available immediately, or if immediate availability cannot reasonably and practically be achieved, any search query must begin operating on the data not later than one hour after the search query is made.

(f) Surveillance. Every national securities exchange and national securities association subject to this section shall develop and implement a surveillance system, or enhance existing surveillance systems, reasonably designed to make use of the consolidated information contained in the consolidated audit trail.

(g) Compliance by Members.

(1) Each national securities exchange and national securities association shall file with the Commission pursuant to section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)) and §240.19b-4 on or before [120 days from approval of this rule] a proposed rule change to require

its members to comply with the requirements of this section and the national market system plan submitted pursuant to this section and approved by the Commission of which the national securities exchange or national securities association is a sponsor.

(2) Each member of a national securities exchange or national securities association that is a sponsor of the national market system plan submitted pursuant to this section and approved by the Commission shall collect and submit to the central repository the information required by paragraph (c) of this section and shall comply with the synchronization requirements of paragraph (d) of this section.

(3) The national market system plan submitted pursuant to this section shall include a provision that by subscribing to and submitting the plan to the Commission, each national securities exchange and national securities association that is a sponsor to the plan agrees to enforce compliance by its members with the provisions of the plan.

(4) The national market system plan submitted pursuant to this section shall include a mechanism to ensure compliance with the requirements of the plan by the members of a national securities exchange or national securities association that is a sponsor of the national market system plan submitted pursuant to this section and approved by the Commission.

(h) Compliance by National Securities Exchanges and National Securities Associations

(1) Each national securities exchange and national securities association shall comply with the provisions of the national market system plan submitted pursuant to this section and approved by the Commission of which it is a sponsor.

(2) Any failure by a national securities exchange or national securities association to comply with the provisions of the national market system plan submitted pursuant to this section

and approved by the Commission of which it is as sponsor shall be considered a violation of this section.

(3) The national market system plan submitted pursuant to this section shall include a mechanism to ensure compliance by the sponsors of the plan with the requirements of the plan.

(i) Other Securities and Other Types of Transactions. The national market system plan submitted pursuant to this section shall include a provision requiring each national securities exchange and national securities association to jointly provide to the Commission within two months after effectiveness of the national market system plan a document outlining how such exchanges and associations would propose to incorporate into the consolidated audit trail information with respect to equity securities that are not NMS securities, debt securities, primary market transactions in NMS stocks, primary market transactions in equity securities that are not NMS securities, and primary market transactions in debt securities, including details for each order and reportable event that would be required to be provided, which market participants would be required to provide the data, an implementation timeline, and a cost estimate.

(j) Definitions.

(1) The term customer shall mean:

(i) The beneficial owner(s) of the account originating the order; and

(ii) The person exercising investment discretion for the account originating the order,

if different from the beneficial owner(s);

(2) The term customer account information shall include, but not be limited to, account number, account type, customer type, date account opened, and large trader identifier (if applicable).

(3) The term material terms of the order shall include, but not be limited to, the NMS security symbol, security type, price (if applicable), size (displayed and non-displayed), side (buy/sell), order type; if a sell order, whether the order is long, short, short exempt; if a short sale, the locate identifier, open/close indicator, time in force (if applicable), whether the order is solicited or unsolicited, whether the account has a prior position in the security; if the order is for a listed option, option type (put/call), option symbol or root symbol, underlying symbol, strike price, expiration date, and open/close, and any special handling instructions.

(4) The term order shall mean:

(i) Any order received by a member of a national securities exchange or national securities association from any person;

(ii) Any order originated by a member of a national securities exchange or national securities association; or

(iii) Any bid or offer.

(5) The term reportable event shall include, but not be limited to, the receipt, origination, modification, cancellation, routing, and execution (in whole or in part).

By the Commission.



Elizabeth M. Murphy  
Secretary

May 26, 2010

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 240 and 241**

**[Release No. 34-62184A; File No. S7-15-09]**

**RIN 3235-AJ66**

**Amendment to Municipal Securities Disclosure**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule and interpretation.

**SUMMARY:** The Securities and Exchange Commission (“Commission” or “SEC”) is adopting amendments to Rule 15c2-12 (“Rule 15c2-12” or “Rule”) under the Securities Exchange Act of 1934 (“Exchange Act”) relating to municipal securities disclosure. The amendments revise certain requirements regarding the information that a broker, dealer, or municipal securities dealer acting as an underwriter in a primary offering of municipal securities must reasonably determine that an issuer of municipal securities or an obligated person has undertaken, in a written agreement or contract for the benefit of holders of the issuer’s municipal securities, to provide to the Municipal Securities Rulemaking Board (“MSRB”). Specifically, the amendments require a broker, dealer, or municipal securities dealer to reasonably determine that the issuer or obligated person has agreed to provide notice of specified events in a timely manner not in excess of ten business days after the event’s occurrence; amend the list of events for which a notice is to be provided; and modify the events that are subject to a materiality determination before triggering a requirement to provide notice to the MSRB. In addition, the amendments revise an exemption from the Rule for certain offerings of municipal securities with put features (defined below as “demand securities”). The Commission also is providing interpretive

guidance intended to assist municipal securities brokers, dealers, and municipal securities dealers in meeting their obligations under the antifraud provisions of the federal securities laws.

**DATES:** Effective Date: [60 days after publication in the Federal Register], except Part 241 will be effective [insert date of publication in the Federal Register].

Compliance Date: December 1, 2010 with respect to §240.15c2-12.

**FOR FURTHER INFORMATION CONTACT:** Martha Mahan Haines, Assistant Director and Chief, Office of Municipal Securities, at (202) 551-5681; Nancy J. Burke-Sanow, Assistant Director, Office of Market Supervision, at (202) 551-5620; Mary N. Simpkins, Senior Special Counsel, Office of Municipal Securities, at (202) 551-5683; Molly M. Kim, Special Counsel, Office of Market Supervision, at (202) 551-5644; Rahman J. Harrison, Special Counsel, Office of Market Supervision, at (202) 551-5663; and Steven Varholik, Special Counsel, Office of Market Supervision, at (202) 551-5615, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

**SUPPLEMENTARY INFORMATION:** The Commission is adopting amendments to Rule 15c2-12 under the Exchange Act.<sup>1</sup>

**I. Executive Summary**

On July 24, 2009, the Commission published for comment amendments to Rule 15c2-12 to improve the quality and timeliness of information about municipal securities that are outstanding in the secondary market.<sup>2</sup> The proposed amendments would have required a broker, dealer, or municipal securities dealer to reasonably determine that the issuer or obligated person has undertaken, in a written agreement or contract for the benefit of holders of the issuer's

<sup>1</sup> 17 CFR 240.15c2-12.

<sup>2</sup> See Securities Exchange Act Release No. 60332 (July 17, 2009), 74 FR 36831 (July 24, 2009) ("Proposing Release"). The comment period for the proposed amendments expired on September 8, 2009.

municipal securities (“continuing disclosure agreement”), to provide notice to the MSRB of specified events in a timely manner not in excess of ten business days after the event’s occurrence. The proposal also would have amended the list of events for which a notice is to be provided and would have modified the events that are subject to a materiality determination before triggering the obligation to submit a notice to the MSRB. In addition, the amendments would have revised an exemption from the Rule for certain offerings of demand securities.

The Commission received twenty-nine comment letters in response to the proposed amendments from a wide range of commenters.<sup>3</sup> The respondents included the MSRB; state and local governments; mutual funds; trade organizations representing broker-dealers, government financial officials, and bond lawyers; and individual investors. Of the comment letters received, four expressed support for the proposed amendments; ten expressed support, but suggested modifications to certain provisions of the proposed amendments; three supported some of the proposed amendments and objected to others; and eight opposed the proposed amendments. In addition, four comment letters neither expressed support for nor opposed the proposed amendments.

Some of the main concerns raised in the comment letters include: (i) the burden and costs associated with the proposed maximum ten business day time frame for submission of event notices; (ii) application of the proposed amendments to remarketings of demand

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<sup>3</sup> Copies of all comments received on the proposed amendments are available on the Commission’s Internet Web site, located at <http://www.sec.gov/comments/s7-15-09/s71509.shtml>. Comments are also available for Web site viewing and printing in the Commission’s Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Exhibit A, which is attached to this release, contains a citation key to the comment letters received by the Commission on the proposed amendments.



securities;<sup>4</sup> and (iii) the proposed removal of the materiality condition from various disclosure events that trigger submission of an event notice to the MSRB. A number of commenters offered alternative approaches to the proposal to address their concerns and made suggestions regarding implementation of the proposed amendments. Also, some commenters addressed two proposals submitted by the MSRB relating to modifications to its Electronic Municipal Market Access (“EMMA”) system.<sup>5</sup>

This release describes and addresses only those portions of the comment letters that are relevant to the proposed amendments. The portions of the comment letters that discuss the MSRB proposals relating to the EMMA system are being considered separately in the Commission’s orders approving the MSRB proposals.<sup>6</sup>

The Commission has carefully considered all the comments it received regarding the proposed amendments and, as discussed below, is adopting the amendments substantially as proposed, with some modifications in response to comments. The amendments are intended to enhance the quality and availability of information about outstanding municipal securities. For the reasons discussed in this release,<sup>7</sup> the Commission believes that the amendments are consistent with the Commission’s mandate to, among other things, adopt rules reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices in the market for

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<sup>4</sup> See infra note 28 and accompanying text for a description of demand securities.

<sup>5</sup> See Securities Exchange Act Release Nos. 60314 (July 15, 2009), 74 FR 36300 (July 22, 2009); 61238 (December 23, 2009), 75 FR 492 (January 5, 2010); 60315 (July 15, 2009), 74 FR 36294 (July 22, 2009); and 61237 (December 23, 2009), 75 FR 485 (January 5, 2010). The EMMA system is a component of the MSRB’s central municipal securities document repository for the collection and availability of continuing disclosure documents over the Internet. See <http://emma.msrb.org>.

<sup>6</sup> See Securities Exchange Act Release Nos. 62182 (May 26, 2010) (SR-MSRB-2010-09) and 62183 (May 26, 2010) (SR-MSRB-2010-10) (pursuant to delegated authority).

<sup>7</sup> See also Proposing Release, supra note 2, 74 FR 36831.

municipal securities. In addition, the Commission is issuing interpretive guidance that is substantially the same as the guidance set forth in the Proposing Release and that is intended to assist municipal securities brokers, dealers, and municipal securities dealers in meeting their obligations under the antifraud provisions of the federal securities laws.

## II. Background

Rule 15c2-12 is intended to enhance disclosure, and thereby reduce fraud, in the municipal securities market by establishing standards for obtaining, reviewing, and disseminating information about municipal securities by their underwriters.<sup>8</sup> In 1989, the Commission adopted paragraphs (a) and (b)(1) – (4) of Rule 15c2-12<sup>9</sup> to require brokers, dealers, and municipal securities dealers (“Participating Underwriters”) acting as underwriters in primary offerings of municipal securities of \$1,000,000 or more (subject to certain exemptions set forth in paragraph (d) of the Rule) to obtain, review, and distribute to potential customers copies of the issuer’s official statement.<sup>10</sup> In 1994, the Commission adopted paragraph (b)(5) of the Rule (“1994 Amendments”),<sup>11</sup> which became effective in 1995 and was amended in 2008.<sup>12</sup> Paragraph (b)(5) prohibits Participating Underwriters from purchasing or selling municipal securities covered by the Rule in a primary offering, unless the Participating Underwriter has

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<sup>8</sup> See Securities Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799 (July 10, 1989) (“1989 Adopting Release”). For additional information relating to the history of the Rule, see Securities Exchange Act Release Nos. 34961 (November 10, 1994), 59 FR 59590 (November 17, 1994) (“1994 Amendments Adopting Release”) and 59062 (December 5, 2008), 73 FR 76104 (December 15, 2008) (“2008 Amendments Adopting Release”).

<sup>9</sup> See 1989 Adopting Release, supra note 8.

<sup>10</sup> 17 CFR 240.15c2-12(a).

<sup>11</sup> 17 CFR 240.15c2-12(b)(5).

<sup>12</sup> See 1994 Amendments Adopting Release and 2008 Amendments Adopting Release, supra note 8.

reasonably determined that an issuer or an obligated person<sup>13</sup> of municipal securities has undertaken in a continuing disclosure agreement to provide specified information to the MSRB in an electronic format as prescribed by the MSRB.<sup>14</sup> The information to be provided consists of: (1) certain annual financial and operating information and audited financial statements (“annual filings”);<sup>15</sup> (2) notices of the occurrence of any of eleven specific events (“event notices”);<sup>16</sup> and (3) notices of the failure of an issuer or obligated person to make a submission required by a continuing disclosure agreement (“failure to file notices”).<sup>17</sup>

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<sup>13</sup> The term “obligated person” means “any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations of the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).” See 17 CFR 240.15c2-12(f)(10).

<sup>14</sup> On December 5, 2008, the Commission adopted amendments to Rule 15c2-12 (“2008 Amendments”) to provide for a single centralized repository, the MSRB, for the electronic collection and availability of information about outstanding municipal securities in the secondary market. Specifically, the 2008 Amendments require a Participating Underwriter to reasonably determine that the issuer or obligated person has undertaken in its continuing disclosure agreement to provide the continuing disclosure documents: (1) solely to the MSRB; and (2) in an electronic format and accompanied by identifying information, as prescribed by the MSRB. See 2008 Amendments Adopting Release, supra note 8. See also Securities Exchange Act Release No. 58255 (July 30, 2008), 73 FR 46138 (August 7, 2008) (“2008 Proposing Release”). The 2008 Amendments became effective on July 1, 2009.

<sup>15</sup> 17 CFR 240.15c2-12(b)(5)(i)(A) and (B).

<sup>16</sup> 17 CFR 240.15c2-12(b)(5)(i)(C). Currently, the following events, if material, require notice: (1) principal and interest payment delinquencies; (2) non-payment related defaults; (3) unscheduled draws on debt service reserves reflecting financial difficulties; (4) unscheduled draws on credit enhancements reflecting financial difficulties; (5) substitution of credit or liquidity providers, or their failure to perform; (6) adverse tax opinions or events affecting the tax-exempt status of the security; (7) modifications to rights of security holders; (8) bond calls; (9) defeasances; (10) release, substitution, or sale of property securing repayment of the securities; and (11) rating changes. In addition, Rule 15c2-12(d)(2) provides an exemption from the application of paragraph (b)(5) of the Rule with respect to certain primary offerings if, among other things, the issuer or obligated person has agreed to a limited disclosure obligation. See 17 CFR 240.15c2-12(d)(2). As discussed in detail in Section III.C. below, the

Since the adoption of the 1994 Amendments, the amount of outstanding municipal securities has more than doubled to \$2.8 trillion.<sup>18</sup> Notably, despite this large increase in the amount of outstanding municipal securities, direct investment in municipal securities by individuals remained relatively steady from 1996 to 2009, ranging from approximately 35% to 39% of outstanding municipal securities.<sup>19</sup> At the end of 2009, individual investors held approximately 35% of outstanding municipal securities directly and up to another 34% indirectly through money market funds, mutual funds, and closed end funds.<sup>20</sup> There is also substantial trading volume in the municipal securities market. According to the MSRB, almost \$3.8 trillion of long and short term municipal securities were traded in 2009 in over 10 million transactions.<sup>21</sup>

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Commission is adopting amendments to the Rule to eliminate the materiality determination for certain of these events.

<sup>17</sup> 17 CFR 240.15c2-12(b)(5)(i)(D). Annual filings, event notices, and failure to file notices are referred to collectively herein as “continuing disclosure documents.”

<sup>18</sup> According to statistics assembled by the Securities Industry and Financial Markets Association (“SIFMA”), the amount of outstanding municipal securities grew from approximately \$1.26 trillion in 1996 to \$2.81 trillion at the end of 2009. See SIFMA Holders of U.S. Municipal Securities (available at [http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA\\_USMunicipalSecurities\\_Holders.pdf](http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USMunicipalSecurities_Holders.pdf)) (“SIFMA Report”). As noted in the Proposing Release, the amount of outstanding municipal securities was \$2.69 trillion at the end of 2008, according to statistics assembled by SIFMA. See Proposing Release, supra note 2, 74 FR at 36834, n. 16 and accompanying text.

<sup>19</sup> See SIFMA Report, supra note 18. As noted in the Proposing Release, direct investment in municipal securities by individuals from 1996 to 2008 ranged from approximately 35% to 39% of outstanding municipal securities, according to statistics assembled by SIFMA. See Proposing Release, supra note 2, 74 FR at 36834, n. 17 and accompanying text.

<sup>20</sup> See SIFMA Report, supra note 18. As noted in the Proposing Release, at the end of 2008, individual investors held approximately 36% of outstanding municipal securities directly and up to another 36% indirectly through money market funds, mutual funds, and closed end funds, according to statistics assembled by SIFMA. See Proposing Release, supra note 2, 74 FR at 36834, n. 18 and accompanying text.

<sup>21</sup> See MSRB, Real-Time Transaction Reporting, Statistical Patterns in the Municipal Market, Monthly Summaries 2009 (available at [http://www.msrb.org/msrb1/TRSweb/MarketStats/statistical\\_patterns\\_in\\_the\\_muni.htm](http://www.msrb.org/msrb1/TRSweb/MarketStats/statistical_patterns_in_the_muni.htm)).

Further, there are approximately 51,000 state and local issuers of municipal securities, ranging from villages, towns, townships, cities, counties, and states, as well as special districts, such as school districts and water and sewer authorities.<sup>22</sup>

In addition, municipal bonds can and do default. In fact, at least 917 municipal bond issues went into monetary default during the 1990s, with a defaulted principal amount of over \$9.8 billion.<sup>23</sup> Bonds for healthcare, multifamily housing, and industrial development, together with land-backed debt, accounted for more than 80% of defaulted dollar amounts.<sup>24</sup> In 2007, a total of \$226 million in municipal bonds defaulted (including both monetary and covenant

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As noted in the Proposing Release, in 2008, almost \$5.5 trillion of long and short term municipal securities were traded in 2008 in nearly 11 million transactions. See Proposing Release, supra note 2, 74 FR at 36834, n. 19 and accompanying text.

<sup>22</sup> See, e.g., Report on Transactions in Municipal Securities prepared by Office of Economic Analysis and Office of Municipal Securities, the Division of Market Regulation, Commission, (July 1, 2004) (available at <http://www.sec.gov/news/studies/munireport2004.pdf>).

<sup>23</sup> See Standard and Poor's, A Complete Look at Monetary Defaults in the 1990s (June, 2000) (available at <http://www.kennyweb.com/kwnext/mip/paydefault.pdf>) ("Standard and Poor's Report"). See also Moody's Investors Service, The U.S. Municipal Bond Rating Scale: Mapping to the Global Rating Scale And Assigning Global Scale Ratings to Municipal Obligations (March, 2008) (available at [http://www.moody.com/cust/content/content.ashx?source=StaticContent/Free%20pages/Credit%20Policy%20Research/documents/current/102249\\_RM.pdf](http://www.moody.com/cust/content/content.ashx?source=StaticContent/Free%20pages/Credit%20Policy%20Research/documents/current/102249_RM.pdf)) (regarding municipal defaults of Moody's rated municipal securities).

<sup>24</sup> See Standard and Poor's Report, supra note 23. See also Proposing Release, supra note 2, 74 FR at 36834.

defaults).<sup>25</sup> In 2008, 140 issuers defaulted on \$7.6 billion in municipal bonds.<sup>26</sup> There are reports that approximately \$5 billion in municipal bonds are in default today.<sup>27</sup>

The Commission's experience with the operation of the Rule over the past 20 years, changes in the municipal market since the adoption of the 1994 Amendments, and recent market events have suggested the need for the Commission to reconsider certain aspects of the Rule. In particular, the Commission proposed amendments to the Rule's exemption for primary offerings of municipal securities in authorized denominations of \$100,000 or more which, at the option of the holder thereof, may be tendered to the issuer or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by the issuer or its designated agent ("demand securities").<sup>28</sup>

As the Commission discussed in the Proposing Release, at the time the Rule was adopted in 1989, demand securities were relatively new to the municipal market.<sup>29</sup> Approximately \$13 billion of variable rate demand obligations ("VRDOs")<sup>30</sup> were issued in 1989.<sup>31</sup> However, by

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<sup>25</sup> See Joe Mysak, Subprime Finds New Victim as Muni Defaults Triple, Bloomberg News, May 30, 2008.

<sup>26</sup> See Joe Mysak, Municipal Defaults Don't Reflect Tough Times: Chart of Day, Bloomberg News, May 28, 2009 (also noting that since 1999, issuers have defaulted on \$24.13 billion in municipal bonds).

<sup>27</sup> See, e.g., Mary Williams Walsh, State Debt Woes Grow Too Big to Camouflage, The New York Times, March 30, 2010.

<sup>28</sup> 17 CFR 240.15c2-12(d)(1)(iii).

<sup>29</sup> See Proposing Release, supra note 2, 74 FR at 36834-5.

<sup>30</sup> The Commission is not currently aware of any demand securities that were not issued as VRDOs. The MSRB describes VRDOs as "[f]loating rate obligations that have a nominal long-term maturity but have a coupon rate that is reset periodically (e.g., daily or weekly). The investor has the option to put the issue back to the trustee or tender agent at any time with specified (e.g., seven days') notice. The put price is par plus accrued interest." See [http://www.msrb.org/MSRB1/glossary/view\\_def.asp?vID=4310](http://www.msrb.org/MSRB1/glossary/view_def.asp?vID=4310).

<sup>31</sup> See Two Decades of Bond Finance: 1989-2008, The Bond Buyer/Thomson Reuters 2009 Yearbook 4 (Matthew Kreps ed., Source Media, Inc.) (2009).

2009, it has been reported that approximately \$32 billion of VRDOs were issued,<sup>32</sup> with trading in VRDOs representing approximately 34% of trading volume of all municipal securities.<sup>33</sup> Further, it has been reported that as of early 2009, the outstanding amount of VRDOs was estimated at approximately \$400 billion.<sup>34</sup> During the fall of 2008, the VRDO market experienced significant volatility.<sup>35</sup> As the size, volatility, and complexity of the VRDO market and the number of investors have grown, so have the risks associated with less complete disclosure. Moreover, representatives of the primary purchasers of VRDOs – money market funds – have expressed concerns suggesting that the exemption in Rule 15c2-12 for these securities may no longer be justified.<sup>36</sup> These developments highlight the need for the

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<sup>32</sup> See Thomson Reuters, “A Decade of Municipal Bond Finance” (available at [http://www.bondbuyer.com/marketstatistics/decade 1](http://www.bondbuyer.com/marketstatistics/decade%201)).

<sup>33</sup> According to the MSRB, trading volume in VRDOs in 2009 was approximately \$1.3 trillion. Total trading volume in 2009 for all municipal securities was approximately \$3.8 trillion. See E-mail between Martha M. Haines, Assistant Director and Chief, Office of Municipal Securities, Division, Commission, and Marcelo Vieira, Director of Research, MSRB, January 26, 2010. As noted in the Proposing Release, in 2008, approximately \$115 billion of VRDOs were issued, with trading in VRDOs representing approximately 38% of trading volume of all municipal securities. See Proposing Release, *supra* note 2, 74 FR at 36834, n. 27 and accompanying text.

<sup>34</sup> See Andrew Ackerman, Regulation: MSRB Files Disclosure Proposals; Board Offers Four New Rules to SEC, *The Bond Buyer*, July 15, 2009. See also Proposing Release, *supra* note 2, 74 FR at 36834 and n. 27.

<sup>35</sup> See Diya Gullapalli, Crisis On Wall Street: Muni Money-Fund Yields Surge – Departing Investors Send 7-Day Returns Over 5%, *Wall Street Journal*, September 27, 2008; Andrew Ackerman, Short-Term Market Dries Up: Illiquidity Leads to Lack of Bank LOCs, *The Bond Buyer*, October 7, 2008. (“The reluctance of financial firms to carry VRDOs is evident in the spike in the weekly [SIFMA] municipal swap index, which is based on VRDO yields and spiked from 1.79% on Sept. 10 to 7.96% during the last week of the month. It has since declined somewhat to 5.74%.”). See also Proposing Release, *supra* note 2, 74 FR at 36834, n. 33.

<sup>36</sup> See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute (“ICI”), to Florence E. Harmon, Secretary, Commission (July 25, 2008) (available at <http://www.sec.gov/comments/s7-13-08/s71308-44.pdf>); comments of participants in the 2001 SEC Municipal Market Roundtable – “Secondary Market Disclosure for the 21st Century,” (available at

Commission to improve the availability to investors of important information regarding demand securities.

The Commission believes that investors and other municipal market participants today should be able to obtain continuing disclosure information regarding demand securities so that they can make more knowledgeable investment decisions and effectively manage and monitor their investments so as to reduce the likelihood of fraud facilitated by inadequate disclosure. Accordingly, the Commission is modifying the exemption in the Rule, as discussed below, for demand securities<sup>37</sup> by requiring Participating Underwriters to reasonably determine that the

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<http://www.sec.gov/info/municipal/roundtables/thirdmuniround.htm>) (Leslie Richards-Yellen, Principal, The Vanguard Group: “. . . what I’d like to see change the most is the inclusion of securities that have been carved out of Rule 15c2-12. I would like securities such as money market securities to be within the ambit of Rule 15c2-12. In addition, I’d like to see the eleven material events be expanded. The first eleven were very helpful. The ICI drafted a letter and we’ve added another twelve for the industry to think about and cogitate on . . .”, and Dianne McNabb, Managing Director, A.G. Edwards & Sons, Inc: “I think that in summary, we could use more specificity as far as what needs to be disclosed, the timeliness of that disclosure, such as the financial statements, more events, I think that we would agree that there are more events . . .”); and National Federation of Municipal Analysts, Recommended Best Practices in Disclosure for Variable Rate and Short-Term Securities, February, 2003 (recommendations for continuing disclosures of specified information) (available at [http://www.nfma.org/publications/short\\_term\\_030207.pdf](http://www.nfma.org/publications/short_term_030207.pdf)); see Proposing Release, *supra* note 2, 74 FR at 36834, n. 15. See also ICI Letter at 5 (“We support the proposed amendment to improve VRDO disclosure . . . . Specifically, the availability of continuing disclosure information regarding VRDOs would greatly benefit investors by enhancing their ability to make and monitor their investment decisions and protect themselves from misrepresentations and questionable conduct in this segment of the municipal securities market.”), and Fidelity Letter at 2. Fidelity indicated in its letter that it assisted in the preparation of the ICI Letter and expressed support for all of the statements made in the ICI Letter.

<sup>37</sup> See 17 CFR 240.15c2-12(d)(1)(iii). Specifically, the Commission is eliminating the exemption for primary offerings of demand securities contained in paragraph (d)(1)(iii) of the Rule and adding new paragraph (d)(5) to the Rule. Paragraph (d)(5) of the Rule, as revised, exempts primary offerings of demand securities from all of the provisions of the Rule except those relating to a Participating Underwriter’s obligations pursuant to paragraph (b)(5) of the Rule and relating to recommendations by brokers, dealers, and municipal securities dealers pursuant to paragraph (c) of the Rule. As discussed in



issuer of demand securities, or any obligated person, has undertaken in a written agreement to provide continuing disclosure documents to the MSRB.

As discussed in detail below, the Commission is adopting, substantially as proposed, the amendments to Rule 15c2-12. In sum, the Commission is modifying, substantially as proposed, the Rule's exemption for demand securities by deleting current paragraph (d)(1)(iii) and adding new paragraph (d)(5) to the Rule, thereby applying the continuing disclosure requirements of paragraphs (b)(5) and (c) of the Rule<sup>38</sup> to a primary offering of demand securities. The amendments also modify, as proposed, paragraph (b)(5)(i)(C) of the Rule, thereby requiring all Participating Underwriters to reasonably determine that the issuer or obligated person has undertaken in a continuing disclosure agreement to provide event notices to the MSRB in a timely manner not in excess of ten business days, rather than merely in "a timely manner."

In addition, the Commission is adopting, with a few revisions from the proposal in the Proposing Release, an amendment to paragraph (b)(5)(i)(C) of the Rule relating to adverse tax events. Under the amendment, as revised from the proposal in the Proposing Release, this event item includes "the issuance by the IRS of proposed or final determinations of taxability, Notices

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Section III.A. below, the Commission is adopting a modified version of its initial proposal to cover demand securities issued on or after the amendments' compliance date. As a result of these changes, Participating Underwriters, in connection with a primary offering of demand securities, will need to reasonably determine that the issuer or obligated person has entered into a continuing disclosure agreement with respect to the submission of continuing disclosure documents to the MSRB. In addition, brokers, dealers, and municipal securities dealers recommending the purchase or sale of demand securities will need to have procedures in place that provide reasonable assurance that they would receive prompt notice of event notices and failure to file notices. See 17 CFR 240.15c2-12(c).

<sup>38</sup> See supra notes 11 through 16 and accompanying text for a description of paragraph (b)(5) of the Rule. Paragraph (c) of the Rule requires a broker, dealer, or municipal securities dealer that recommends the purchase or sale of a municipal security to have procedures in place that provide reasonable assurance that it will receive prompt notification regarding any event notice and any failure to file notice related to the municipal security. See 17 CFR 240.15c2-12(c).

of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security or other material events affecting the tax status of the security.”

The amendments also add, as proposed, the following events to paragraph (b)(5)(i)(C) of the Rule: (1) tender offers; (2) bankruptcy, insolvency, receivership or similar event of the issuer or obligated person; (3) the consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material; and (4) appointment of a successor or additional trustee, or the change of name of a trustee, if material.

Finally, the amendments delete the general materiality condition from paragraph (b)(5)(i)(C) of the Rule. In connection with the deletion of the general materiality condition from paragraph (b)(5)(i)(C) of the Rule, the amendments also add a materiality condition to select events contained in paragraph (b)(5)(i)(C) of the Rule. For those events in paragraph (b)(5)(i)(C) of the Rule that do not contain a materiality condition, Participating Underwriters will now need to reasonably determine that an issuer or obligated person has undertaken in a written agreement to provide notice of such events in all circumstances. These events include: (1) principal and interest payment delinquencies with respect to the securities being offered; (2) unscheduled draws on debt service reserves reflecting financial difficulties; (3) unscheduled draws on credit enhancements reflecting financial difficulties; (4) substitution of credit or liquidity providers, or their failure to perform; (5) defeasances; and (6) rating changes.

### III. Discussion of Amendments and Comments Received

#### A. Modification of the Exemption for Demand Securities

As discussed in the Proposing Release, generally there are no continuing disclosure agreements for demand securities today because primary offerings of these securities are currently exempt from the Rule.<sup>39</sup> When the Rule was adopted in 1989, the Commission exempted demand securities from its coverage in response to concerns that the Rule “might unnecessarily hinder the operation of the market”<sup>40</sup> for VRDOs, or similar securities. Paragraphs (b)(1) – (4) of the Rule require a Participating Underwriter to review an official statement that the issuer “deems final” before it may bid for, purchase, offer, or sell municipal securities in an offering, deliver preliminary and final official statements to any potential customer, on request, and contract with the issuer to receive an adequate number of the final official statements to fulfill its regulatory responsibilities. Although remarketings of VRDOs may be primary offerings,<sup>41</sup> the Commission did not impose the requirements of paragraphs (b)(1) – (4) of the Rule on Participating Underwriters of each remarketing – which could occur as frequently as weekly, and sometimes even daily, for each outstanding demand security – in part because of the burden this could impose on Participating Underwriters to comply with the

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<sup>39</sup> See Proposing Release, supra note 2, 74 FR at 36836.

<sup>40</sup> See 1989 Adopting Release, supra note 8, 54 FR at 28808, n. 68. See also Proposing Release, supra note 2, 74 FR at 36836.

<sup>41</sup> See Rule 15c2-12(f)(7) for the definition of “primary offering.” 17 CFR 240.15c2-12(f)(7). Making a determination concerning whether a particular remarketing of demand securities is a primary offering by the issuer of the securities requires an evaluation of relevant provisions of the governing documents, the relationship of the issuer to the other parties involved in the remarketing transaction, and other facts and circumstances pertaining to such remarketing, particularly with respect to the extent of issuer involvement.

Rule's provisions.<sup>42</sup> The Commission, in the 1994 Amendments Adopting Release, did not specifically address the application of paragraph (b)(5) of the Rule, which currently requires Participating Underwriters to reasonably determine that an issuer of municipal securities or an obligated person<sup>43</sup> has undertaken in a continuing disclosure agreement to provide specified information to the MSRB, to remarketings of demand securities.<sup>44</sup>

As discussed above, the Commission today is modifying the Rule's exemption for demand securities because its experience with the operation of the Rule and market changes since the adoption of the 1994 Amendments have suggested a need to reconsider its scope. The increased issuance, trading volume, and outstanding dollar amount of VRDOs indicate that many more investors currently own such securities than when the Rule was adopted in 1989.<sup>45</sup> Further, despite the periodic ability to tender VRDOs to issuers for repurchase, some investors, such as mutual funds, appear to hold VRDOs for long periods of time and therefore have a need for continuing disclosure information about the issuer or obligated person.<sup>46</sup>

Accordingly, the Commission believes that developments since 1989 warrant narrowing the Rule's provision exempting demand securities from continuing disclosure obligations in

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<sup>42</sup> See 1989 Adopting Release, supra note 8, 54 FR at 28808 and n. 68. See also Proposing Release, supra note 2, 74 FR at 36836.

<sup>43</sup> The term "obligated person" means "any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations of the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities)." See 17 CFR 240.15c2-12(f)(10).

<sup>44</sup> See 1994 Amendments Adopting Release, supra note 8.

<sup>45</sup> As stated in the Proposing Release, the increased investment interest and activity in VRDOs during 2008 may be attributable, in part, to the turmoil in the market for auction rate securities ("ARS") that began in February 2008. See Proposing Release, supra note 2, 74 FR at 36834 and 36835, n. 48.

<sup>46</sup> See Proposing Release, supra note 2, 74 FR at 36835, n. 45.

order to improve the availability of information to investors. Indeed, representatives of money market funds, the primary purchasers of demand securities, have expressed difficulty or, on some occasions, the inability to obtain information that they believe is necessary to oversee their investments in demand securities.<sup>47</sup> By narrowing the exemption for demand securities, the Commission intends to improve the availability of continuing disclosures, not only to institutional investors, such as mutual funds, that acquire these securities for their portfolios, but also to individual investors who own, or who may be interested in owning, demand securities. The availability of information regarding demand securities, in turn, should help institutional and individual investors make more informed decisions with respect to investments in those securities and should reduce the likelihood that such investors will be subject to fraud facilitated by inadequate disclosure. The Commission believes that broader requirements for consistent and accurate disclosure of important information should enhance the efficiency of the relevant capital market segments by better allocating capital at appropriate prices.

Consequently, the Commission is deleting the exemption for demand securities<sup>48</sup> set forth in paragraph (d)(1)(iii) of the Rule and adding new paragraph (d)(5) to the Rule, thereby making the continuing disclosure provisions of paragraphs (b)(5)<sup>49</sup> and (c)<sup>50</sup> of the Rule apply to a primary offering<sup>51</sup> of demand securities.<sup>52</sup> This change applies to any primary offering of demand securities (including a remarketing that is a primary offering) occurring on or after the

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<sup>47</sup> See Proposing Release, supra note 2, 74 FR at 36836.

<sup>48</sup> See supra note 28 and accompanying text.

<sup>49</sup> See supra note 14 and accompanying text.

<sup>50</sup> See supra note 38 for a description of Rule 15c2-12(c).

<sup>51</sup> See Rule 15c2-12(f)(7) for the definition of primary offering. 17 CFR 240.15c2-12(f)(7).

<sup>52</sup> See supra note 41.

compliance date of the amendments.<sup>53</sup> However, as more fully discussed below,<sup>54</sup> the Commission is revising the amendment from that proposed to include a “limited grandfather provision” (as defined below) for remarketings of currently outstanding demand securities.<sup>55</sup> Specifically, the continuing disclosure provisions will not apply to remarketings of demand securities that are outstanding in the form of demand securities on the day preceding the compliance date of the amendments and that continuously have remained outstanding<sup>56</sup> in the form of demand securities.

Thus, as amended, paragraph (d)(2)(B)(5) of the Rule states that “[w]ith the exception of paragraphs (b)(1) - (4), this section shall apply to a primary offering of municipal securities in authorized denominations of \$100,000 or more if such securities may, at the option of the holder thereof, be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent; provided, however, that paragraphs (b)(5) and (c) shall not apply to such securities outstanding as of November 30, 2010 for so long as they continuously remain in authorized denominations of \$100,000 or more and may, at the option of the holder thereof, be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until

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<sup>53</sup> As noted in Section III.G., the compliance date of the amendments to the Rule adopted herein is December 1, 2010.

<sup>54</sup> See *infra* notes 111 and 112 and accompanying text, as well as the paragraph following the accompanying text.

<sup>55</sup> See *infra* note 112 and accompanying text for discussion of comments related to the limited grandfather provision.

<sup>56</sup> “Outstanding” generally means bonds that have been issued but have not yet matured or been otherwise redeemed. See, e.g., MSRB Glossary of Municipal Security Terms at [http://www.msrb.org/msrb1/glossary/glossary\\_db.asp?sel=o](http://www.msrb.org/msrb1/glossary/glossary_db.asp?sel=o).

maturity, earlier redemption, or purchase by an issuer or its designated agent” (emphasis added to indicate revised language) (“limited grandfather provision”).<sup>57</sup>

In the Proposing Release, the Commission requested comment on whether it is appropriate to revise the Rule’s exemption for demand securities. The Commission specifically requested comment regarding investors’ and other municipal market participants’ need for continuing disclosure information relating to demand securities and the extent to which the amendment would provide benefits to these individuals. The Commission also requested comment regarding the effect of the amendment on Participating Underwriters, issuers, obligated persons, and others.

Commenters were generally supportive of applying the continuing disclosure provisions of paragraph (b)(5) of the Rule to demand securities, so that a Participating Underwriter of these securities will be required to reasonably determine that the issuer or obligated person has entered into a continuing disclosure agreement to submit continuing disclosure documents to the MSRB.<sup>58</sup> A number of commenters agreed that applying continuing disclosure obligations to

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<sup>57</sup> The Commission also is slightly modifying the text of paragraph (d)(2)(B)(5) of the Rule from the version in the Proposing Release to clarify that demand securities remain exempt from paragraphs (b)(1)-(4) of the Rule, consistent with the Commission’s description and discussion of the amendment in the Proposing Release.

<sup>58</sup> See California Letter at 1, CHEFA Letter at 2, Connecticut Letter at 1, DAC Letter at 3, e-certus Letter I at 11, Fidelity Letter at 3, Folts Letter at 1, ICI Letter at 2, NFMA Letter at 1, RBDA Letter at 2, and SIFMA Letter at 2.

Although the Commission is eliminating certain exemptions, demand securities will continue to be exempt from paragraphs (b)(1) – (4) of the Rule. In other words, a Participating Underwriter of a demand security will continue to be exempt from the obligation to review an official statement that the issuer “deems final” before it may bid for, purchase, offer, or sell municipal securities. Some commenters urged the Commission to eliminate the exemption for demand securities from these provisions. See Fidelity Letter at 3 and RBDA Letter at 2, and SIFMA Letter at 2. One commenter expressed concern that not requiring Participating Underwriters to comply with these provisions with regard to demand securities suggests that the information required in the continuing disclosure documents may not be material for investors at the initial issuance

demand securities is “critical” to assist investors in making informed investment decisions.<sup>59</sup>

One commenter noted that the market for VRDOs was among the sectors most affected by the recent market turmoil and, consequently, there is good reason to increase the availability of information about these securities to investors.<sup>60</sup> Similarly, another commenter stated that, during the recent market downturn, investors in VRDOs were well served by those issuers or obligated persons who voluntarily provided continuing disclosure documents, despite the Rule’s exemption.<sup>61</sup>

Further, two commenters noted that application of paragraph (b)(5) of the Rule to demand securities might not significantly increase the disclosure burdens for many issuers and obligated persons.<sup>62</sup> One commenter noted that, because many VRDO issuers are already subject to continuing disclosure undertakings for their fixed rate debt, extending these obligations to VRDOs would impose minimal additional burdens, while enhancing disclosure to a much broader segment of investors.<sup>63</sup> Two commenters also noted that, as issuers of VRDOs, they have for a number of years voluntarily entered into continuing disclosure undertakings for those securities.<sup>64</sup>

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of the demand securities. See SIFMA Letter at 2. The Commission believes that it is important for investors to have adequate information in order to make informed investment decisions. The Commission also notes that many official statements are prepared for demand securities. See <http://www.emma.msrb.org>.

<sup>59</sup> See ICI Letter at 5. See also SIFMA Letter at 2 and RBDA Letter at 2.

<sup>60</sup> See RBDA Letter at 2. See also Fidelity Letter at 2.

<sup>61</sup> See CHEFA Letter at 2.

<sup>62</sup> See Connecticut Letter at 1 and NFMA Letter at 1.

<sup>63</sup> See NFMA Letter at 1.

<sup>64</sup> See California Letter at 1 and Connecticut Letter at 1.



Two commenters, however, disputed the assessment that extending paragraph (b)(5) to demand securities would not significantly increase the disclosure burdens for issuers and obligated persons.<sup>65</sup> These commenters focused particularly on the impact the amendment would have on borrowers who access tax-exempt debt markets through demand securities that are fully backed by direct-pay letters of credit (“LOC-backed demand securities”). One of the commenters noted that many of these are non-governmental conduit borrowers<sup>66</sup> who have no previous undertakings to provide continuing disclosure information and, for such entities, complying with paragraph (b)(5) of the Rule would not merely be an extension of preexisting obligations but a new and significant burden.<sup>67</sup> Moreover, the two commenters opposing the proposed change stated that many obligated persons with respect to LOC-backed demand securities do not prepare annual filings, such as audited financial statements, in the ordinary course of their business.<sup>68</sup> They therefore believed that eliminating the exemption from paragraph (b)(5) would impose costs and burdens that could potentially force some conduit borrowers using LOC-backed demand securities to withdraw from the tax-exempt bond market.<sup>69</sup>

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<sup>65</sup> See CRRC Letter at 3-5 and NABL Letter at A-10.

<sup>66</sup> A “conduit borrower” is an obligated person for whose benefit a state, political subdivision, municipality, or governmental agency or authority may issue tax-exempt municipal bonds. The security for this type of issue is customarily the credit of the conduit borrower or pledged revenues from the project financed, rather than the credit of the issuer. See, e.g., definitions of “conduit financing,” “conduit borrower,” and “issuer” in Glossary of Municipal Securities Terms (Second Edition - January 2004) of the MSRB, available at [http://www.msrb.org/msrb1/glossary/glossary\\_db.asp?sel=c](http://www.msrb.org/msrb1/glossary/glossary_db.asp?sel=c).

<sup>67</sup> See NABL Letter at A-2, n. 1.

<sup>68</sup> See CRRC Letter at 5 and NABL Letter at A-2.

<sup>69</sup> See CRRC Letter at 5 and NABL Letter at A-10. Two commenters also expressed concern that, in complying with the revised Rule, smaller and not-for-profit obligated persons could encounter similar costs and burdens. See NABL Letter at A-2 (noting that many small businesses and non-profit organizations utilize LOC-backed demand securities in accessing the tax-exempt debt markets) and SIFMA Letter at 2-3. See also Section VI.B.2(c).

As the Commission stated in the Proposing Release, it does not anticipate a significant increase in disclosure burdens with respect to demand securities.<sup>70</sup> Those issuers with outstanding demand securities – including LOC-backed demand securities – will have the limited grandfather provision available to them, and thus likely will not be subject to an undertaking to provide continuing disclosures for those securities. The Commission acknowledges that, if issuers of demand obligations, or obligated persons, have not previously issued securities that were subject to the Rule (i.e., municipal securities other than demand securities), they will be entering into a continuing disclosure agreement for the first time and thereby will incur some costs and burdens to provide continuing disclosure documents to the MSRB.<sup>71</sup> However, as the Commission noted in proposing these amendments, a number of issuers of VRDOs, and obligated persons, already have outstanding fixed rate municipal securities, and some of these securities likely are subject to continuing disclosure agreements under the Rule.<sup>72</sup> Because any existing continuing disclosure agreement obligates an issuer or an obligated person to provide annual filings, event notices, and failure to file notices with respect to these fixed rate securities, providing disclosures by such issuers or obligated persons with respect to VRDOs is not expected to be a significant additional burden.<sup>73</sup> As the Commission stated in proposing these amendments,<sup>74</sup> it believes that any additional burden on issuers and obligated persons<sup>75</sup> with

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<sup>70</sup> See Proposing Release, supra note 2, 74 FR at 36837.

<sup>71</sup> Id.

<sup>72</sup> See Proposing Release, supra note 2, 74 FR at 36837.

<sup>73</sup> See infra Section V.D. for a discussion regarding burden on issuers and obligated persons that do not currently provide annual filings, event notices, or failure to file notices.

<sup>74</sup> See Proposing Release, supra note 2, 74 FR at 36837.

<sup>75</sup> The Commission estimates that the amendment to modify the exemption from the Rule for a primary offering of demand securities would increase the number of issuers with

respect to demand securities is, on balance, justified by the enhancements to investor protection that should result from the improved availability of information with respect to these securities as a result of the amendments.<sup>76</sup> As noted above, a number of commenters supported this view.<sup>77</sup>

Regarding the concern that any new disclosure burdens may induce some obligated persons to withdraw from the tax-exempt municipal market because they do not prepare annual filings in the ordinary course of their business, the Commission notes that, for purposes of the Rule, annual filings are required only to the extent provided in the final official statements. Specifically, annual filings are composed of: (1) audited financial statements, when and if available; and (2) other financial and operating data of the type included in the official statement. Pursuant to the undertaking contemplated by the Rule, annual financial information must be submitted for “each obligated person for whom financial information or operating data is presented in the final official statement. . . .”<sup>78</sup> Annual financial information is defined as “financial information or operating data. . . of the type included in the final official statement with respect to an obligated person. . . .”<sup>79</sup> As the Commission previously stated, the definition of annual financial information specifies both the timing of the information—that is, once a year—and, by referring to the final official statement, the type of financial information and operating data that is to be provided.<sup>80</sup> If financial information or operating data concerning an

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municipal securities offerings that are subject to the Rule annually by 20%. See *infra* Section V.D.

<sup>76</sup> For discussion of the burdens associated with the modification of the Rule as it relates to demand securities, see *supra* Section V.D.

<sup>77</sup> See, e.g., CHEFA Letter at 2, Connecticut Letter at 1, e-certus Letter I at 11, Folts Letter at 1, ICI Letter at 5, NFMA Letter at 1, RBDA Letter at 2, and SIFMA Letter at 2.

<sup>78</sup> 17 CFR 240.15c2-12(b)(5)(i)(A).

<sup>79</sup> 17 CFR 240.15c2-12(f)(9).

<sup>80</sup> See 1994 Amendments Adopting Release, *supra* note 8, 59 FR at 59598.

obligated person is included in the final official statement, then annual financial information would consist of the same type of financial information or operating data.<sup>81</sup>

Further, pursuant to paragraph (b)(5)(i)(B) of the Rule, audited financial statements need to be submitted, pursuant to the issuer's and obligated person's undertaking in a continuing disclosure agreement, only "when and if available."<sup>82</sup> This limitation, which is consistent with the Commission's position in the 1994 Amendments Adopting Release, should mitigate some concerns of those obligated persons that do not prepare audited financial statements in the ordinary course of their business.<sup>83</sup> Further, although not all issuers or obligated persons, in the ordinary course of their business, prepare audited financial statements or other financial and operating information of the type included in annual filings, a number of issuers and obligated persons do.<sup>84</sup>

The Commission acknowledges that issuers or obligated persons of demand obligations that assemble financial and operating data for the first time in response to their undertakings in a continuing disclosure agreement may incur incremental costs beyond those costs incurred by those issuers or obligated persons that already assemble this information. Also, smaller issuers

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<sup>81</sup> Id. See paragraph (f)(3) of the Rule for the definition of "final official statement." 17 CFR 240.15c2-12(f)(3).

<sup>82</sup> 17 CFR 240.15c2-12(b)(5)(i)(B).

<sup>83</sup> As discussed in the 1994 Amendments Adopting Release, the 1994 Amendments "[do] not adopt the proposal to mandate audited financial statements on an annual basis with respect to each issuer and significant obligor. Instead, the amendments require annual financial information, which may be unaudited, and may, where appropriate and consistent with the presentation in the final official statement, be other than full financial statements. . . . However, if audited financial statements are prepared, then when and if available, such audited financial statements will be subject to the undertaking and must be submitted to the repositories. Thus . . . the undertaking must include audited financial statements only in those cases where they otherwise are prepared." See 1994 Amendments Adopting Release, supra note 8, 59 FR at 59599.

<sup>84</sup> See <http://www.emma.msrb.org> for audited financial statements or other financial and operating information submitted to EMMA.

or obligated persons may have relatively greater burdens than larger issuers or obligated persons. However, the overall burdens for these demand securities issuers or obligated persons in preparing financial information are expected to be commensurate with those of issuers or obligated persons that already are preparing financial information as part of their continuing disclosure undertakings.<sup>85</sup> The Commission believes that the burdens that will be incurred in the aggregate by issuers or obligated persons, as a result of the amendments with respect to demand securities, may not be significant and, in any event, are justified by the benefits to investors of enhanced disclosure.<sup>86</sup> The Commission further believes that the operations of an issuer or obligated person generally entail the preparation and maintenance of at least some financial and operating data.

The Commission also stated in the Proposing Release, and reiterates herein, its belief that the application of paragraph (b)(5) to demand securities will not significantly burden Participating Underwriters in connection with the initial issuance and remarketing of demand securities. Any primary offering, including a remarketing of demand securities that is a primary offering (other than those subject to the limited grandfather provision), that occurs on or after the

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<sup>85</sup> Further, issuers or obligated persons that assemble financial and operating data for the first time may face a greater burden than those issuers or obligated persons that already assemble this information. The amendments therefore initially may have a disparate impact on those issuers or obligated persons, including small entities, entering into a continuing disclosure agreement for the first time, as compared with those that already have outstanding continuing disclosure agreements.

<sup>86</sup> See *infra* Section V.D. As discussed therein, some commenters believed that the amendment could force some small entities to withdraw from the tax-exempt market because: (1) disclosure of small issuers' or obligated persons' financial information would provide their large, national competitors with information about these small issuers or obligated persons, which they believed could result in a competitive disadvantage to them; and (2) small issuers or obligated persons would have to prepare costly audited financial statements. See, e.g., CRRRC Letter at 3-4 and WCRRC Letter at 1. As discussed above, the undertakings contemplated by the amendments (and Rule 15c2-12 in general) require annual financial information only to the extent provided in the final official statement, and audited financial statements only when and if available.

compliance date of the Rule will require a Participating Underwriter (including a Participating Underwriter serving as a remarketing agent)<sup>87</sup> to make a determination that an issuer or an obligated person has entered into a continuing disclosure agreement. Subsequent determinations for remarketings of the same issue of demand securities should not be burdensome because, once the Participating Underwriter has made such a determination for a particular issue of demand securities, at the time of a subsequent remarketing, the Participating Underwriter will be aware of the existence of the continuing disclosure agreement. Furthermore, remarketing agents that did not previously participate in an offering of such securities could confirm that an issuer or an obligated person has entered into an undertaking by obtaining an official statement from the issuer, the MSRB,<sup>88</sup> or from a variety of vendors. Such an official statement by definition must include a description of the issuer's undertakings.<sup>89</sup> In addition, a remarketing agent could obtain a copy of the actual continuing disclosure agreement from the issuer or obligated person at the time that it enters into a contract to act as a remarketing agent.<sup>90</sup>

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<sup>87</sup> A remarketing agent is a broker-dealer responsible for reselling to new investors securities (such as VRDOs) that have been tendered for purchase by their owner. The remarketing agent also typically is responsible for resetting the interest rate for a variable rate issue and also may act as tender agent. See Proposing Release, supra note 2, 74 FR at 36836, n. 53. Further, a remarketing agent often serves as the Participating Underwriter in the initial issuance of the demand security.

<sup>88</sup> The MSRB makes official statements for public offerings of municipal securities available on the Internet through its EMMA system for free. See Securities Exchange Act Release No. 59061 (December 5, 2008), 73 FR 75778 (December 12, 2008) (File No. SR-MSRB-2008-05) (order approving the MSRB's proposed rule change to make permanent a pilot program for an Internet-based public access portal for the consolidated availability of primary offering information about municipal securities). See also supra note 5 and MSRB Rule G-32.

<sup>89</sup> 17 CFR 240.15c2-12(f)(3).

<sup>90</sup> One commenter believed the elimination of the exemption for LOC-backed demand securities would substantially increase a Participating Underwriter's burden in offering and remarketing these securities because the Participating Underwriter must: (1) determine whether information concerning the obligated person is material and (2) if

Some commenters argued that the amendment is too broad.<sup>91</sup> Specifically, these commenters stated that the amendment should not apply to conduit borrowers of LOC-backed demand securities, but rather to the letter of credit providers.<sup>92</sup> They stated that, for these securities, a bond trustee draws on the letters of credit issued by banks or financial institutions, rather than the underlying borrowers, for all payments of interest and principal, and to repurchase

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material, review the offering document to assure that it includes financial or operating data about the obligated person. In addition, this commenter stated that a Participating Underwriter would be required by the antifraud provisions of the Securities Act of 1933 and the Exchange Act to reasonably investigate key representations about the obligated person in the offering document before passing the securities along to investors and periodically repeat its “due diligence” of the obligated person before acting as a remarketing agent for primary offerings of such demand securities. See NABL Letter at A-11. However, such obligations of a Participating Underwriter already exist under the antifraud provisions of the federal securities laws.

<sup>91</sup> See CRRC Letter at 2, NABL Letter at 2, and WCRRC Letter at 1 (endorsing CRRC Letter in its entirety). One of these commenters maintained that the Commission should not adopt the amendment relating to demand securities without Congressional authority. The commenter stated that the Commission does not have the “statutory authority to regulate the content of prospectuses used to offer exempt securities, except possibly under the authority of the antifraud provisions of the federal securities laws.” See NABL Letter at A-7. The Commission notes that the amendments do not address the contents of prospectuses used to offer exempt securities and, instead, are being adopted, among other things, pursuant to its authority under Section 15(c)(2)(D) of the Exchange Act, 15 U.S.C. 78o(c)(2)(D), which grants the Commission authority to define, and to prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive or manipulative.

<sup>92</sup> See CRRC Letter at 2 and NABL Letter at 2.

Separately, another commenter remarked about the responsibilities of an issuer with respect to the underlying obligor of a demand security. The commenter stated that, “if it is the SEC’s intention to have issuers disclose information either in the official statement or on a continuing basis regarding the underlying obligor,” issuers would be significantly burdened because they do not have such information first-hand. See GFOA Letter at 2. The Commission notes that its rulemaking does not amend provisions of Rule 15c2-12 relating to official statements. The Commission notes that, as with other conduit borrowings, issuers may require an obligated person of demand obligations to execute a continuing disclosure agreement as a condition of issuance, such that the underlying obligor bears the responsibility of providing continuing disclosures to the MSRB.

the securities if and when they are tendered.<sup>93</sup> Consequently, information in disclosure documents for some LOC-backed demand securities relates to the entities issuing the letters of credit, and not the conduit borrowers.<sup>94</sup> These commenters argued that, if the Commission applies paragraph (b)(5) of the Rule to LOC-backed demand securities,<sup>95</sup> the obligation to provide continuing disclosures should be imposed on the banks and financial institutions that provide credit enhancements, and not on the conduit borrowers.<sup>96</sup>

As noted in the Proposing Release, the Commission believes that information regarding conduit borrowers is material to investors in credit enhanced offerings and therefore should be included in the official statements.<sup>97</sup> As the Commission has stated before in the context of municipal securities offerings as well as other types of securities offerings, the existence of credit enhancement is not a substitute for information about the underlying obligor or other obligated entity.<sup>98</sup> For example, Regulation AB, relating to disclosures in offerings of asset-backed securities, requires disclosure about the underlying pool of assets in addition to disclosures about credit enhancement and credit enhancement providers.<sup>99</sup> Furthermore, for VRDOs, as well as fixed rate securities, many governmental issuers and conduit borrowers routinely provide full disclosure about themselves in official statements, suggesting that they consider this information

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<sup>93</sup> Id. See also NABL Letter at A-1.

<sup>94</sup> See CRRC Letter at 2 and NABL Letter at A-2 and A-6.

<sup>95</sup> See CRRC Letter at 2-3 and NABL Letter at 1-2.

<sup>96</sup> See CRRC Letter at 3.

<sup>97</sup> See Proposing Release, supra note 2, 74 FR at 36844, n. 113, citing 1989 Adopting Release, supra note 8, 54 FR at 28812.

<sup>98</sup> See 1989 Adopting Release, supra note 8, 54 FR at 28812 (“The presence of credit enhancements generally would not be a substitute for material disclosure concerning the primary obligor on municipal bonds.”)

<sup>99</sup> 17 CFR 229.1100 – 1123.



to be useful to investors.<sup>100</sup> The Commission also notes that it is possible for the issuers of credit enhancements, including letters of credit providers, to default on their obligations<sup>101</sup> or to have their ratings downgraded.<sup>102</sup> The possibility of such occurrences supports the likelihood that investors would consider information concerning the underlying obligor important to making investment decisions.

With respect to demand securities, one commenter stated that the Rule should not be amended to apply continuing disclosure requirements to demand securities, because owners of demand securities can choose to terminate their investment by exercising the option to put such

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<sup>100</sup> For example, governmental obligors, non-profit health care facilities, colleges, and universities routinely provide disclosures about themselves in official statements. *See, e.g.*, Connecticut Letter at 1; Official Statement dated November 4, 2009 for VRDOs issued by the Arizona Health Facilities Authority for the benefit of Catholic Healthcare West (available at <http://emma.msrb.org/EP346945-EP47480-EP669523.pdf>); Official Statement dated August 22, 2008 for VRDOs issued by the Health and Educational Authority of the State of Missouri for the benefit of Saint Louis University (available at <http://emma.msrb.org/OSPreview/OSPreview.aspx?documentId=MS271933&transactionId=MS274477>); Official Statement dated October 12, 1994 for VRDOs of the City of Akron Ohio for its Sanitary Sewer System (available at <http://emma.msrb.org/OSPreview/OSPreview.aspx?documentId=MS80311&transactionId=MS105003>); and Official Statement dated April 15, 2005 for VRDOs of the Redevelopment Agency of the City and County of San Francisco Community Facilities District No. 7 for Hunters Point Shipyard Phase One Improvements (available at <http://emma.msrb.org/MS233193-MS208501-MD405363.pdf>).

<sup>101</sup> Since 1995, the Federal Deposit Insurance Corporation ("FDIC") has taken the position that it may not honor unsecured letters of credit issued by financial institutions that are placed in FDIC receivership. *See* FDIC Statement of Policy regarding Treatment of Collateralized Letters of Credit after Appointment of the FDIC as Conservator or Receiver, 60 FR 27976, May 26, 1995, effective May 19, 1995.

<sup>102</sup> *See* Proposing Release, *supra* note 2, 74 FR at 36839. In addition to the ratings downgrades of almost all issuers of municipal bond insurance over the past two years, the ratings of many issuers of letters of credit on municipal bonds were downgraded by one or more credit rating agencies. *See, e.g.*, Jack Herman, S&P Downgrades Ratings or Revises Outlooks on 22 Banks, *The Bond Buyer*, June 19, 2009 ("Standard & Poor's Wednesday downgraded its ratings or revised its outlooks on 22 U.S. banks - more than half of which have provided letters of credit on municipal securities - to reflect the ongoing change in the banking industry."); Dan Seymour, 1st-Half Credit Enhancers See a Topsy-Turvy World, *The Bond Buyer*, July 16, 2009.

securities for repurchase at face value or more, at least as frequently as every nine months.<sup>103</sup>

The commenter argued that these investors can therefore sufficiently protect their investments.<sup>104</sup>

Further, the commenter noted that when investors need financial and operating data to evaluate their investments, they are able to get such information from conduit borrowers, who typically provide the information voluntarily in order to support pricing and remarketing.<sup>105</sup> The commenter also questioned the need for the amendment when investors, as a condition to purchasing or maintaining an investment in demand securities, are free to demand undertakings to provide notices of certain events.<sup>106</sup>

The Commission does not believe that an investor's ability to tender a demand security for repurchase obviates the need for continuing disclosures. While a holder of demand obligations, such as VRDOs, may tender these securities for repurchase at par value,<sup>107</sup> when the investor is unable to obtain necessary information to make an informed decision as to whether to continue to hold demand securities, the investor may have no other option but to tender. However, the Commission does not believe that such outcome is in the interest of the investing public or the municipal securities market. Without adequate information about the issuer or obligated person, including annual financial information and audited annual financial statements, it would be difficult for an investor to evaluate whether to buy, hold, sell, or put the security. Moreover, most holders of VRDOs are money market funds<sup>108</sup> subject to the requirements of

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<sup>103</sup> See NABL Letter at A-4 – A-6.

<sup>104</sup> Id.

<sup>105</sup> See NABL Letter at A-8.

<sup>106</sup> See NABL Letter at A-8 and A-9.

<sup>107</sup> See 17 CFR 240.15c2-12(d)(1)(iii).

<sup>108</sup> See, e.g., Standard & Poor's, Variable Rate Demand Obligations – A Primer: A Short Guide to Variable Rate Demand Obligations and the S&P National AMT-Free Municipal

Rule 2a-7 under Investment Company Act of 1940 (“Investment Company Act”),<sup>109</sup> with an obligation to monitor the securities in their funds.<sup>110</sup> The availability of continuing disclosure information should facilitate the fulfillment of these obligations. The Commission also notes that one commenter, whose membership includes many money market funds, stated that “the availability of continuing disclosure information regarding VRDOs would greatly benefit investors by enhancing their ability to make and monitor their investment decisions and protect themselves from misrepresentations and questionable conduct in this segment of the municipal securities market.”<sup>111</sup>

Some commenters sought clarification with respect to the proposed amendment relating to demand securities. Specifically, some commenters asked the Commission to clarify the meaning of “primary offering” with respect demand securities<sup>112</sup> and asked for guidance to distinguish remarketings that are primary offerings requiring continuing disclosure agreements from those that are not primary offerings.<sup>113</sup> These comments appear to be based upon the concern that the amendments could require a broker, dealer, or municipal securities dealer to obtain continuing disclosure documents for demand securities that were issued prior to the compliance date of the amendments.

The Commission acknowledges that, although there may be beneficial effects from subjecting outstanding demand obligations to paragraphs (b)(5) and (c) of the Rule, regardless of

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VRDO Index, November 1, 2009 (available at [http://www2.standardandpoors.com/spf/pdf/index/VRDO\\_Primer.pdf](http://www2.standardandpoors.com/spf/pdf/index/VRDO_Primer.pdf)).

<sup>109</sup> 17 CFR 270.2a-7.

<sup>110</sup> 17 CFR 270.2a-7(c)(3)(iv).

<sup>111</sup> See ICI Letter at 6. See also Fidelity Letter at 2.

<sup>112</sup> See Kutak Letter at 2, NABL Letter at 4-5 and A-11, and SIFMA Letter at 2.

<sup>113</sup> Id.

their date of initial issuance, doing so may be unduly burdensome and costly for certain market participants. For example, if all outstanding issuances of demand securities, such as VRDOs which generally are long-term securities,<sup>114</sup> became subject to paragraph (b)(5)(i)(C) of the Rule, it would be necessary for a Participating Underwriter, in the first remarketing of each issue of demand securities following the compliance date of the amendments, to reasonably determine that an issuer or obligated person has executed a continuing disclosure agreement. For such an agreement to be consistent with the Rule, a Participating Underwriter must reasonably determine that the issuer or obligated person has agreed to provide “[a]nnual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final official statement.”<sup>115</sup> However, for outstanding issues of demand securities, referring back to information included in the final official statement may be problematic because that document may be many years old. Without the limited grandfather provision, issuers and obligated persons would be required under continuing disclosure agreements to update annual financial information that may no longer be prepared or available. In addition, application of the amendments to remarketings of demand securities occurring on or after the compliance date could necessitate a large number of issuers and obligated persons of demand securities to enter into continuing disclosure agreements in a very short time period, which could delay remarketings and temporarily negatively impact the market for demand securities.

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<sup>114</sup> See supra Section II. for statistics on the amount of outstanding VRDOs.

<sup>115</sup> 17 CFR 240.15c2-12(b)(5)(i)(A).

The Commission has considered the potentially significant difficulties and costs associated with implementing the amendment with respect to outstanding demand securities and the potential negative implications this may have on the demand securities market and investors.<sup>116</sup> As a result, the Commission has revised its original proposal to include a limited grandfather provision so that paragraphs (b)(5) and (c) of the Rule are not applicable to demand obligations outstanding in the form of demand securities immediately prior to the compliance date of these amendments, and that have remained continuously outstanding in the form of demand securities.<sup>117</sup> The Commission believes that the adoption of the limited grandfather provision strikes an appropriate balance between the need to improve disclosure available to investors and the recognition that the practical effects of applying paragraphs (b)(5) and (c) of the Rule to outstanding issues of demand securities could unduly burden certain issuers and obligated persons and thus may adversely impact the market. Although the Commission recognizes that the amendment to demand securities now is narrower than what was originally proposed, the Commission does not believe that the change detracts from the benefits of greater information about new issuances of demand obligations that the amendment will foster. The

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<sup>116</sup> See infra Section VI.B. for a detailed description of costs associated with implementing this change.

<sup>117</sup> Two commenters also expressed confusion regarding the application of paragraph (b)(5)(i)(A) of the Rule to demand securities. Paragraph (b)(5)(i)(A) requires that continuing disclosure agreements include annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement. These commenters specifically questioned how Participating Underwriters would comply with the requirement in the limited instances where no final official statement was or is produced with respect to a demand security or when the final official statement that is produced contains no information regarding the underlying obligor. See NABL Letter at 2-3 and A-9 and SIFMA Letter at 2. The Commission believes that demand securities are purchased primarily by tax-exempt money market funds and that money market funds typically require official statements. See, e.g., Kutak Letter at 2 (commenting that VRDOs are typically targeted to money market funds) and NABL Letter at A-1 (acknowledging that demand securities are an important part of the investment portfolio of most tax-exempt money market funds).

Commission believes that the burdens of continuing disclosure obligations, noted above, with respect to these securities justify the benefits, and the grandfather provision is consistent with other amendments that have been applied on a prospective basis.<sup>118</sup> Further, the Commission notes that some issuers and obligated persons of demand securities also have issued fixed rate municipal securities, and thus are subject to existing continuing disclosure obligations.

In conclusion, the Commission continues to believe that any additional burden imposed on Participating Underwriters, issuers, obligated persons, the MSRB, or others as a result of the amendment to the Rule relating to demand securities is justified by the benefits to investors of enhanced disclosure with respect to this important and widely-held type of security. Eliminating the exemption for demand securities, subject to the limited grandfather provision regarding demand securities outstanding as of the day prior to the amendments' compliance date, will improve the availability of information about these securities and should reduce the likelihood that investors will be subject to fraud facilitated by inadequate disclosure. Further, access to more information will assist money market funds<sup>119</sup> in complying with their obligations under Rule 2a-7 of the Investment Company Act.<sup>120</sup> The Commission also believes that the amendment will assist a broker, dealer, or municipal securities dealer in fulfilling its

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<sup>118</sup> See also infra Section VI.B.4.

<sup>119</sup> See supra note 47.

<sup>120</sup> 17 CFR 270.2a-7.

responsibilities to its customers,<sup>121</sup> specifically by facilitating the disclosure of important facts and complying with suitability and other sales practice obligations.<sup>122</sup>

B. Time Frame for Submitting Event Notices under a Continuing Disclosure Agreement

The Commission is adopting the amendment to paragraph (b)(5)(i)(C) of the Rule<sup>123</sup> to require a Participating Underwriter to reasonably determine that the issuer or obligated person has agreed in its continuing disclosure agreement to submit event notices to the MSRB “in a timely manner not in excess of ten business days after the occurrence of the event,” rather than “in a timely manner” as the Rule currently provides. The Commission also is adopting a substantially similar revision to the limited undertaking in paragraph (d)(2)(ii)(B) of the Rule.<sup>124</sup>

Eighteen commenters provided their views on the proposed ten business day time period for the submission of event notices pursuant to a continuing disclosure agreement.<sup>125</sup> The majority of commenters opposed the proposal. Some commenters opposed establishing any outside time frame,<sup>126</sup> while others specifically objected to the proposed ten business day time

<sup>121</sup> For example, a broker, dealer, or municipal securities dealer with access to annual filings and event notices submitted to the MSRB will be able to use information disclosed in these filings and notices when deciding to recommend the purchase or sale of a particular demand security. See, e.g., MSRB Rule G-17.

<sup>122</sup> See, e.g., the MSRB, Reminder of Customer Protection Obligations in Connection with Sales of Municipal Securities, Interpretative Notice of Rule G-17, dated May 30, 2007 (available at <http://www.msrb.org/msrb1/rules/notg17.htm>).

<sup>123</sup> 17 CFR 240.15c2-12(b)(5)(i)(C).

<sup>124</sup> 17 CFR 240.15c2-12(d)(2)(ii)(B). See *supra* note 16 for a description of Rule 15c2-12(d)(2).

<sup>125</sup> See Halgren Letter, Los Angeles Letter, Portland Letter, CRRRC Letter, WCRRC Letter, NFMA Letter, CHEFA Letter, NAHEFFA Letter, SIFMA Letter, Connecticut Letter, Kutak Letter, ICI Letter, Fidelity Letter, California Letter, San Diego Letter, NABL Letter, GFOA Letter, and Metro Water Letter. See also 1994 Amendments Adopting Release, *supra* note 8, 59 FR at 59601.

<sup>126</sup> See NABL Letter at 5-6, GFOA Letter at 2-3, and Metro Water Letter at 1-2.

period, particularly in the context of certain events.<sup>127</sup> One commenter cited the 1994 Amendments Adopting Release, in which the Commission stated that, at that time, it had not established a specific time frame with respect to submission of event notices because of the wide variety of events and circumstances the issuer could face.<sup>128</sup> This commenter believed that this rationale “was sound logic in 1994, and that it should still apply in 2009.”<sup>129</sup> Another commenter stated that it disagreed “with the SEC that there is systemic abuse with material events not being filed in a timely manner”<sup>130</sup> and argued that the Commission “should not mandate a specific time frame for submissions.”<sup>131</sup>

Four commenters expressed support for the ten business day time frame.<sup>132</sup> Two of these commenters stated that the proposal “would replace the imprecise ‘timely manner’ language in the current Rule.”<sup>133</sup> These commenters also noted that “the absence of a specific time period with respect to ‘timely’ has resulted in event notices being submitted months after the events have occurred,”<sup>134</sup> which has been detrimental “to investors who need this information to make

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<sup>127</sup> See Halgren Letter, Los Angeles Letter, Portland Letter, CRRRC Letter, WCRRC Letter, NFMA Letter, CHEFA Letter, NAHEFFA Letter, SIFMA Letter, Connecticut Letter, Kutak Letter, California Letter, and San Diego Letter. See also the discussion below in this section regarding commenters’ concerns about becoming aware of and submitting notices for events such as rating changes and trustee changes.

<sup>128</sup> See NABL Letter at 5-6.

<sup>129</sup> Id.

<sup>130</sup> See GFOA Letter at 2.

<sup>131</sup> Id.

<sup>132</sup> See NFMA Letter at 1-2, SIFMA Letter at 3, ICI Letter at 6-7, and Fidelity Letter at 2. Fidelity indicated in its letter that it assisted in the preparation of the ICI Letter II and expressed support for all of the statements made in the ICI Letter. See Fidelity Letter at 2.

<sup>133</sup> See ICI Letter at 6 and Fidelity Letter at 2.

<sup>134</sup> Id.



informed investment decisions about when, and which, municipal securities to buy and sell.”<sup>135</sup> Further, they emphasized that they “strongly support the establishment of a definitive timeframe by which event notices must be filed, and have repeatedly called for improvements to the timeliness of municipal securities disclosure.”<sup>136</sup>

These commenters noted that timely submission of event notices directly impacts the pricing of a municipal bond. They posited that “reducing the time between the event and the required notice better informs the market that an event occurred, which is essential to evaluating a bond’s credit quality and pricing.”<sup>137</sup> They further noted that a definitive time frame provides more timely information to pricing evaluation services and relieves them of dependence on bondholders to disclose the required information to them.<sup>138</sup> These commenters asserted that “without the proper notification, bonds could be priced incorrectly until the disclosure had been made.”<sup>139</sup>

As discussed in detail below, the Commission has considered the commenters’ views and suggestions on this issue and continues to believe that the benefits of enabling investors to receive promptly information about important events affecting the issuer justify the incremental costs imposed on issuers and obligated persons as a result of the amendments. It has come to the Commission’s attention,<sup>140</sup> as supported by some commenters,<sup>141</sup> that some event notices

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Id.

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Id.

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Id.

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Id.

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Id.

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See Proposing Release, supra note 2, 74 FR at 36837, n. 69. See, e.g., Elizabeth Carvlin, Trustee for Vigo County, Ind., Agency Taps Reserve Fund for Debt Service, The Bond Buyer, April 2, 2004, at 3 (reporting the filing of a material event notice regarding a draw on debt service reserve fund that occurred in February); Alison L. McConnell, Two More

currently are not submitted until months after the events have occurred. Market participants, on the other hand, have emphasized the importance of the prompt availability of such information.<sup>142</sup>

The Commission believes that delays in providing notice of the events set forth in paragraph (b)(5)(i)(C) of the Rule undermine the effectiveness of the Rule. Delays can, among other things, deny investors important information that they need to make informed decisions regarding whether to buy, sell or hold municipal securities. As noted above, two commenters echoed this sentiment by noting the importance of having timely submission of event notices to maintain the transparency of a municipal security's credit quality and pricing.<sup>143</sup> The Commission anticipates that, in providing for a maximum time frame, the amendments should

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Deals Under Audit By TEB Office, The Bond Buyer, April 5, 2006 (event notice of tax audit filed nine months after audit was opened); Susanna Duff Barnett, IRS Answers Toxic Query; Post 1986 Radioactive Waste Debt Not Exempt, The Bond Buyer, November 2, 2004 (material event notice filed October 29, 2004 regarding IRS technical advice memorandum dated August 27, 2004 that bonds issued to finance certain radioactive solid waste facilities were taxable; related preliminary adverse determination letter was issued in January, 2002); and Michael Stanton, IRS: Utah Pool Bonds Taxable; Issuer Disputes Facts of Case, The Bond Buyer, December 8, 1997 (issuer's receipt of August, 1997 IRS technical advice memorandum concluding certain bonds were taxable was disclosed on December 5, 1997). See also Peter J. Schmitt, Estimating Municipal Securities Continuing Disclosure Compliance: A Litmus Test Approach (available at <http://www.dpcdata.com/html/about-researchpapers.html>).

<sup>141</sup> See supra note 134 and accompanying text.

<sup>142</sup> See Proposing Release, supra note 2, 74 FR 36838, n. 70. See, e.g., National Federation of Municipal Analysts, Recommended Best Practices in Disclosure for General Obligation and Tax-Supported Debt (December 2001) ("Any material event notices, including those required under SEC Rule 15c2-12, should be released as soon as practicable after the information becomes available.") (available at <http://www.nfma.org/disclosure.php>); Peter J. Schmitt, Letter to the Editor, To the Editor: MuniFilings.com: The Once and Future Edgar?, The Bond Buyer, October 9, 2007, Commentary, Vol. 362, No. 32732, at 36 ("[F]iling issues are the sole cause of lack of transparency and disclosure availability in the industry. These filing issues include . . . late filing. . . .").

<sup>143</sup> See ICI Letter at 6 and Fidelity Letter at 2.

foster the availability of more current information about municipal securities, and thereby help promote greater transparency and further enhance investor confidence in the municipal securities market. Furthermore, more up-to-date information about municipal securities is likely to improve the transparency in the market, should increase the efficiency of markets in allocating capital at appropriate prices that reflect the creditworthiness of issuers, which benefits issuers and investors alike, and should reduce the likelihood that investors will be subject to fraud facilitated by inadequate disclosure.

The Commission further believes that more timely information will aid brokers, dealers, and municipal securities dealers in satisfying their obligation to have a reasonable basis to recommend the purchase or sale of municipal securities. The Commission notes that the amendment requires Participating Underwriters to reasonably determine that issuers and obligated persons have contractually agreed to submit event notices in timely manner no later than “ten business days after the occurrence of the event,” rather than simply in a “timely manner.” On the other hand, there will be a significant benefit to investors and municipal market participants, because they will have a greater assurance that information about municipal securities will be available within a specific time frame of an event’s occurrence. Indeed, while issuers and obligated persons under continuing disclosure agreements entered into prior to the compliance date of these amendments would have committed to submit event notices in a timely manner, this amendment will help to make the timing of such submissions more certain in the case of issuers and obligated persons that enter into continuing disclosure agreements on or after the compliance date of these amendments.<sup>144</sup>

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The Commission notes that the ten business day time frame will not apply to continuing disclosure agreements entered into with respect to primary offerings that occurred prior to

One commenter suggested that the Commission leave the current “timely” language in the Rule but provide examples of instances that it considers to be “timely.”<sup>145</sup> The Commission believes that the suggestion solely to provide guidance would not effectively accomplish the Commission’s goal of improving the timeliness of submissions. Moreover, as the Commission noted in the Proposing Release, there have been significant delays in the submission of event notices.<sup>146</sup> As expressed by two commenters, “the absence of a specific time period” with respect to what constitutes timely submission of event notices has been a contributing factor to delays in submitting notices.<sup>147</sup> While one commenter cautioned the Commission against “trying to create a uniform standard for various events that are very different from each other,”<sup>148</sup> it is the Commission’s view that providing a specified time frame will provide clarity regarding the standard to be included in continuing disclosure agreements for timely submission of event notices in all circumstances. In some cases, however, particularly when issuers or obligated persons know about events well in advance, investors may view timely disclosure as occurring within a day or a few days of the event.

Although a number of commenters did not oppose a specified time frame for submission of event notices, they also did not support the ten business day proposal. Some of their concerns were: (i) the impracticability of meeting the time frame because of limited staff and resources,

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the compliance date of these amendments or to remarketings of demand securities that qualify for the limited grandfather provision. See infra Section III.G.

<sup>145</sup> See NABL Letter at 6.

<sup>146</sup> See supra note 140.

<sup>147</sup> See ICI Letter at 6 and Fidelity Letter at 3.

<sup>148</sup> See GFOA Letter at 2.

especially for smaller issuers;<sup>149</sup> (ii) the increased burdens and costs in connection with the additional monitoring and compliance necessary to submit notices within ten business days;<sup>150</sup> (iii) the difficulty in reporting events within ten business days when the issuer does not control the information (e.g., rating changes, changes to the trustee, and changes to the tax status of bonds as a result of an IRS audit);<sup>151</sup> and (iv) the use of the “occurrence of the event” as the trigger for the obligation to submit a notice.<sup>152</sup>

Many of these commenters focused their comments on their concerns about the difficulties associated with providing notice of specified events, particularly rating changes and trustee changes, within ten business days of their occurrence.<sup>153</sup> These commenters noted that rating changes and trustee changes are not within the issuer’s control and that, with respect to rating changes, rating organizations do not directly notify issuers of rating changes.<sup>154</sup> As a result, these commenters believed that it would be difficult for most issuers to submit an event notice for a rating change within ten business days of its occurrence without incurring substantial costs associated with monitoring for rating changes.

Some commenters, who expressed concern about the ability of an issuer to learn of the event and then submit an event notice within the ten business day time frame, proposed

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<sup>149</sup> See CRRC Letter, WCRRC Letter, Portland Letter at 2, NAHEFFA Letter at 2-4, Metro Water Letter at 1-2, CHEFA Letter at 2, and NABL Letter at 5-6.

<sup>150</sup> See Halgren Letter, Los Angeles Letter at 1, CRRC Letter, WCRRC Letter, NAHEFFA Letter at 2-4, CHEFA Letter at 2, and NABL Letter at 5-6.

<sup>151</sup> See Connecticut Letter at 1-2, California Letter 1-2, San Diego Letter at 1-2, NAHEFFA Letter at 2-4, CHEFA Letter at 2, Kutak Letter at 2, and GFOA Letter at 2-3.

<sup>152</sup> See California Letter at 1-2, NAHEFFA Letter at 2-4, CHEFA Letter at 2, San Diego Letter at 1-2, GFOA Letter at 3, Kutak Letter at 2, and NABL Letter at 5-6.

<sup>153</sup> See Halgren Letter, Los Angeles Letter at 1-2, NAHEFFA Letter at 2-4, San Diego Letter at 1-2, CHEFA Letter at 2, Kutak Letter at 2, California Letter at 1-2, NABL Letter at 8, and GFOA Letter at 3-4.

<sup>154</sup> Id.

alternative time periods ranging from 30 to 45 days from the event's occurrence.<sup>155</sup> Others, however, recommended that the Commission reduce the time frame.<sup>156</sup> Two of these commenters advocated a time frame of five business days from the occurrence of the event, which they noted is the amount of time permitted for submitting similar notices in the taxable debt market.<sup>157</sup> Another commenter recommended a time frame of four business days from the occurrence of the event."<sup>158</sup>

Several commenters who opposed the ten business day time frame suggested a number of modifications. Some of these commenters proposed changing the trigger for submission of an event notice from the occurrence of the event to the issuer's actual knowledge of the event.<sup>159</sup> A number of commenters recommended removing "rating changes" from the list of disclosure events and requiring rating organizations to submit their rating changes directly to the MSRB's EMMA system.<sup>160</sup> Finally, one commenter suggested that, instead of specifying a time period, the Commission should modify the Rule to: (1) state that "issuers should disclose material events in a timely manner which in the normal course of business would be 10 business days;" (2) allow the ten business days to run from the time the issuer learned of the event, or 30 calendar days from the event itself; and (3) ensure that in the instances where issuers do not have

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<sup>155</sup> See Halgren Letter, Portland Letter at 2, NAHEFFA Letter at 4, and CHEFA Letter at 2.

<sup>156</sup> See ICI Letter at 7, Fidelity Letter at 2, and e-certus Letter at 8.

<sup>157</sup> See ICI Letter at 7 and Fidelity Letter at 3.

<sup>158</sup> See e-certus Letter I at 8.

<sup>159</sup> See Kutak Letter at 2, California Letter at 1-2, San Diego Letter at 1-2, and CHEFA Letter at 2.

<sup>160</sup> See Halgren Letter, Portland Letter at 2, Los Angeles Letter at 1-2, California Letter at 3, CHEFA Letter at 2, GFOA Letter at 3-4, and NABL Letter at 8.

control of the information (e.g., a rating change due to the rating change of the credit enhancer), the issuer should not be responsible for submitting the information.<sup>161</sup>

The Commission has considered commenters' concerns about the potential costs and burdens associated with the ten business day time period for submission of event notices. The Commission also has considered commenters' suggestion that the triggering event should be actual knowledge of the event rather than the event's occurrence. As the Commission noted in the Proposing Release, however, the events currently specified in paragraph (b)(5)(i)(C) of the Rule, and the additional event items included in the amendments, are significant and should become known to the issuer or obligated person expeditiously.<sup>162</sup> For example, events such as payment defaults, tender offers, and bankruptcy filings generally involve the issuer's or obligated person's participation.<sup>163</sup> Other events (e.g., failure of a credit or liquidity provider to perform) are of such importance that an issuer or obligated person likely will become aware of such events,<sup>164</sup> or will expect an indenture trustee, paying agent, or other transaction participant to

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<sup>161</sup> See GFOA Letter at 3.

<sup>162</sup> See supra note 16 for a description of events currently contained in Rule 15c2-12(b)(5)(i)(C). See infra Section III.E. for a description of events added to the Rule by these amendments.

<sup>163</sup> In addition, as the Commission noted in the Proposing Release, involvement of the issuer or obligated person is often required for substitution of credit or liquidity providers; modifications to rights of security holders; release, substitution, or sale of property securing repayment of the securities; and optional redemptions. See Proposing Release, supra note 2, 74 FR at 36838, n. 73. The Commission received no comments on this statement. See also Form Indenture and Commentary, National Association of Bond Lawyers, 2000.

<sup>164</sup> For example, as the Commission noted in the Proposing Release, issuers or obligated persons should have direct knowledge of principal and interest payment delinquencies, determinations of taxability from the IRS, tender offers that they initiate, and bankruptcy petitions that they file. The Commission received no comments on this statement.

bring them to the issuer's or obligated person's attention, within a very short period of time.<sup>165</sup> Indeed, issuers and obligated persons could seek to obtain contractual agreements to be advised of the occurrence of such events by those persons or entities that may be expected to have direct knowledge of the occurrence.

Consistent with the Commission's discussion in the Proposing Release, rating changes may affect the market price of the security, and thus bondholders and prospective investors should have access to this information.<sup>166</sup> While the Commission recognizes that an event such as a rating change is not directly within the issuer's control, Participating Underwriters today must reasonably determine that the issuer or obligated person has undertaken in a continuing disclosure agreement to provide notice of rating changes, if material.<sup>167</sup> While the Commission notes that the obligation to provide notice of rating changes is not new for those issuers that have issued municipal securities subject to a continuing disclosure agreement, the ten business day time frame may cause some issuers to monitor more actively for rating changes than they do today. The amendments revise the Rule to require the Participating Underwriter to reasonably determine that the continuing disclosure agreement provide for submission of event notices,

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<sup>165</sup> The Commission believes, as noted in the Proposing Release, that indenture trustees generally would be aware of principal and interest payment delinquencies; material non-payment related defaults; unscheduled draws on credit enhancements reflecting financial difficulties; the failure of credit or liquidity providers to perform; and adverse tax opinions. The Commission received no comments on this statement. The Commission notes that issuers and obligated persons may wish to consider negotiating a provision to include in indentures to which they are a party to require a trustee promptly to notify the issuer or obligated person in the event the trustee knows or has reason to believe that an event specified in paragraph (b)(5) of the Rule has or may have occurred.

<sup>166</sup> See Proposing Release, *supra* note 2, 74 FR at 36840.

<sup>167</sup> See *infra* Section IV., discussing the obligations of underwriters of municipal securities under the antifraud provisions of the federal securities laws.



including rating changes and trustee changes (if material), within ten business days after the event's occurrence.

Several commenters raised concerns about meeting the ten business day time frame because of limited resources and staff, particularly with respect to smaller issuers,<sup>168</sup> and the increased burdens and costs associated with monitoring such events within the specified time frame. The Commission recognizes that some issuers, particularly smaller issuers, may require a greater effort initially to comply with their undertakings in continuing disclosure agreements that reflect the revised Rule.<sup>169</sup> The Commission notes that information about rating changes by organizations that rate municipal securities is readily accessible by issuers through the rating agencies' Internet Web sites. In addition, issuers may be able to subscribe to a service that provides them with prompt rating updates for their securities. For other events that may be outside of the issuer's control, such as a trustee change, issuers can contractually arrange to be notified of such an event immediately.<sup>170</sup> Accordingly, the Commission continues to expect that issuers and obligated persons generally will become aware of the Rule's disclosure events (or can make arrangements to ensure that they become aware) within ten business days after the

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<sup>168</sup> See CRRC Letter, WCRRRC Letter, Portland Letter at 2, NAHEFFA Letter at 2-4, Metro Water Letter at 1-2, CHEFA Letter at 2, and NABL Letter at 5-6.

<sup>169</sup> The Commission recognizes that issuers that enter into continuing disclosure agreements for the first time, particularly smaller issuers, initially may need to become familiar with the steps necessary to ascertain whether there has been a rating change, and that there are burdens associated with this.

<sup>170</sup> For example, under a trust indenture, the trustee may be obligated to notify an issuer before the trustee changes its name. See *infra* Section IV., discussing the obligations of underwriters of municipal securities under the antifraud provisions of the federal securities laws.

event's occurrence and accordingly should be able to comply with their undertakings to submit event notices to the MSRB within the ten business day time frame.<sup>171</sup>

The Commission believes that, on balance, the ten business day time frame is appropriate. By specifying a ten business day time frame, the Commission intends to strike a balance between the need for event notices to be disseminated promptly and the need to allow adequate time for an issuer or obligated person to become aware of the event and to prepare and file the notice. The Commission believes that the ten business day time frame provides a reasonable amount of time for issuers to comply with their undertakings, while also allowing event notices to be made available to investors, underwriters, and other market participants in a timely manner.

C. Materiality Determinations Regarding Event Notices

1. Deletion of the Materiality Condition Generally

The Commission proposed to delete in certain instances the materiality condition found in paragraph (b)(5)(i)(C) of the Rule. Based on the Commission's experience with paragraph (b)(5)(i)(C), the Commission believes that notice of certain events currently listed therein need not be preceded by a materiality determination. These events include: (1) principal and interest payment delinquencies with respect to the securities being offered; (2) unscheduled draws on debt service reserves reflecting financial difficulties; (3) unscheduled draws on credit

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<sup>171</sup> As noted in the Proposing Release, those issuers or obligated persons required by Section 13(a) or Section 15(d) of the Exchange Act to report certain events on Form 8-K (17 CFR 249.308) would already make such information public in a Form 8-K. See Proposing Release, supra note 2, 74 FR at 36838, n. 76. The Commission believes that such persons should be able to file material event notices, pursuant to the issuer's or obligated person's undertakings, within a short time after the Form 8-K filing. See 15 U.S.C. 78m and 78o(d). The Commission received no comments on these statements.

enhancements reflecting financial difficulties; (4) substitution of credit or liquidity providers, or their failure to perform; (5) defeasances; and (6) rating changes.

A number of commenters expressed support for deletion of the materiality condition.<sup>172</sup> Two of these commenters stated that “these disclosure events are of such high consequence and relevance to investors in informing their investment decisions that they should be disclosed as a matter of course.”<sup>173</sup> Another commenter noted that “these events should always be provided to investors because their occurrence is always important to investors and other market participants.”<sup>174</sup> One commenter stated that the proposal “to delete a materiality qualifier is not useful, but also would not unduly burden issuers or obligated persons except in three circumstances.”<sup>175</sup>

Three commenters opposed the proposed change.<sup>176</sup> One commenter stated that the elimination of the materiality condition for all the events included in paragraph (b)(5)(i)(C) of the Rule would “increase issuers’ administrative burden for monitoring the possible occurrence of these events.”<sup>177</sup> This commenter also believed that removal of the general materiality

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<sup>172</sup> See NFMA Letter at 2, SIFMA Letter at 3, e-certus Letter at 8, ICI Letter at 7-8, and Fidelity Letter at 3. See also California Letter at 2 and San Diego Letter at 2 (each of these commenters support elimination of the materiality qualifier for each of the six events set forth in the Proposing Release except for the event relating to rating changes); see *infra* Section III.C.2.e. for a discussion of rating changes.

<sup>173</sup> See ICI Letter at 7-8 and Fidelity Letter at 3.

<sup>174</sup> See SIFMA Letter at 8.

<sup>175</sup> See NABL Letter at 6-7. The three circumstances for which this commenter suggested retaining a materiality condition are: (i) unscheduled draws of debt service reserves that reflect financial difficulties for LOC-backed demand securities; (ii) failed remarketings of LOC-backed demand securities; and (iii) defeasances. The Commission addresses each of these three circumstances later in this release. See *infra* Section III.C.2.

<sup>176</sup> See Metro Water Letter at 2, Connecticut Letter at 2, and GFOA Letter at 4.

<sup>177</sup> See Metro Water Letter at 2.

provision may result in the disclosure of non-material events.<sup>178</sup> Another commenter, while acknowledging the importance of these six events, argued that the materiality condition should be retained because “there is a risk that dividing event notices into two categories may introduce confusion where none now exists.”<sup>179</sup> Further, one commenter remarked that “establishing materiality is important in order to ensure that relevant information is passed to investors” and is “best made on a case by case basis, along with advice of counsel.”<sup>180</sup>

The Commission believes that a materiality determination remains appropriate for specific events, as discussed below.<sup>181</sup> However, under the amendments, for each event that no longer is subject to a materiality condition, a Participating Underwriter must reasonably determine that the issuer or obligated person has agreed to submit a notice to the MSRB within ten business days of the event’s occurrence, without regard to its materiality. The Commission believes that each of these events by its nature is of such importance to investors that it should always be disclosed. In particular, these events are likely to have a significant impact on the value of the underlying securities. Moreover, the Commission believes that notice of these events should reduce the likelihood that investors will be subject to fraud facilitated by inadequate disclosure.<sup>182</sup>

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Id.

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See Connecticut Letter at 2.

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See GFOA Letter at 4.

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The discussion in this section pertains to materiality determinations for events currently specified in paragraph (b)(5)(i)(C) of the Rule. For events to be added to the Rule by these amendments, the Commission discusses in Section III.E. below whether the materiality determination has been included for each such event.

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The Commission applied the same rationale discussed in this paragraph to determine which of the new event items that are being added to the Rule by these amendments should contain a materiality condition.

Further, the Commission continues to believe that the removal of the materiality condition for the aforementioned events is not expected to significantly increase the burden on issuers and obligated persons. Because of the significant nature of these events and their importance to investors in the marketplace, the Commission believes that issuers and obligated persons generally are already providing notice of most of these events pursuant to existing continuing disclosure agreements. It is the Commission's view that removing the materiality condition for these six disclosure events will help ensure that important information about significant events regarding municipal securities is promptly provided to investors and other market participants in all instances. The availability of this information to investors will enable them to make informed investment decisions and should reduce the likelihood that investors will be subject to fraud facilitated by inadequate disclosure. Furthermore, this information will assist brokers, dealers and municipal securities dealers in satisfying their obligation to have a reasonable basis to recommend municipal securities to investors. Deletion of the materiality condition also could simplify a determination by an issuer or obligated person with respect to whether a notice must be filed and facilitate their providing such notice promptly. Accordingly, the Commission is adopting the amendment as proposed.

2. Deletion of Materiality Condition for Specific Events

As noted above, some commenters generally supported the proposed revision to the Rule eliminating the general materiality condition from all events, but expressed concerns regarding its elimination for specific events. The Commission discusses these comments below but, for the reasons discussed, is adopting the amendment, as proposed.

a. Principal and Interest Payment Delinquencies

One commenter suggested that, in light of the Commission's proposed amendment to delete the materiality condition from specified events, the definition of "principal and interest payment delinquency" should be clarified to take into account contractual grace periods and similar operational considerations, so that "minor operational variances" would not require event disclosure.<sup>183</sup> Other commenters opposed the deletion of the materiality condition from the principal and interest payment delinquency event because otherwise it may include reporting of certain delays in payment that are the result of circumstances outside of the issuer's control or are very limited in time (e.g., technological glitches; a short-term disruption of the Federal Reserve Wire system; an error or lapse by the trustee or paying agent that is quickly corrected; or clerical error at the Depository Trust Company that is quickly corrected).<sup>184</sup> Two of these commenters noted that these circumstances may result in a "very short-term delay in crediting payments to bondholders" and that "in the past [they] would have treated such an event as not material."<sup>185</sup> Further, these two commenters argued that requiring submission of notices in these circumstances "would create an unwarranted implication that the issuer has suffered financial adversity."<sup>186</sup>

The Commission notes that a payment default often negatively affects the market value of a municipal security and may have adverse consequences for an investor who has an immediate need for such funds. The Commission therefore believes that notice of any payment default with respect to securities covered by the Rule, including those defaults that are quickly remedied or that result from a technological glitch or similar error, is important information for

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<sup>183</sup> See Kutak Letter at 3.

<sup>184</sup> See California Letter at 2, San Diego Letter at 2, and GFOA Letter at 4.

<sup>185</sup> See California Letter at 2 and San Diego Letter at 2.

<sup>186</sup> Id.

investors. The Commission notes that issuers and obligated persons may include the reason for a payment default in the event notice submitted to the MSRB. Delayed payment – even for a short period of time – may impact investors’ investment decisions by inhibiting their ability to promptly reinvest such payment or by leaving them unsure whether to buy, hold, or sell municipal securities. Accordingly, the Commission believes that notice of principal and interest payment delinquencies on municipal securities should always be provided to aid investors in making investment decisions and help protect them from fraud, as well as to assist brokers, dealers, and municipal securities dealers in satisfying their obligation to have a reasonable basis to recommend a municipal security.

b. Unscheduled Draws on Debt Service Reserves or Credit Enhancements Reflecting Financial Difficulties

Unscheduled draws on debt service reserves and credit enhancements often adversely impact the market value of a municipal security and, in the Commission’s view, should always be made available to investors and other market participants.<sup>187</sup> These events likely indicate that the financial condition of a municipal securities issuer or obligated person has deteriorated and that there is, potentially, an increased risk of a payment default or, in some cases, premature redemption. Bondholders and other market participants also would be concerned with the sufficiency of the amount of debt service and other reserves available to support an issuer or obligor through a period of temporary difficulty, as well as the present financial condition of the provider of any credit enhancement.

One commenter suggested that a materiality condition should be retained for unscheduled draws on debt-service reserves for LOC-backed demand securities.<sup>188</sup> This commenter argued

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<sup>187</sup> See Proposing Release, *supra* note 2, 74 FR at 36839.

<sup>188</sup> See NABL Letter at 6-7.

that materiality is necessary in this limited instance because the proposed amendment “would require notice of unscheduled draws on debt service reserves that reflect financial difficulties of the obligated person, even when not material to an investment in the securities because they are traded on the strength of a bank letter of credit.”<sup>189</sup>

The Commission notes that notice is needed only when an unscheduled draw on debt-service reserves or credit enhancement indicates financial difficulties “with respect to the securities.” Thus, an issuer or obligor must consider, under the facts and circumstances of a particular municipal security and its relevant governing documents, whether or not such unscheduled draw reflects financial difficulties with respect to that security – a limitation that should help address some concerns about removal of the materiality condition.

The same commenter also suggested retaining the “if material” condition for LOC-backed demand securities because the deletion of this condition, coupled with the modification to the exemption for demand securities, “would require notice of each failure to remarket securities when they are put, even though not material to an investor due to the existence of a letter of credit or other liquidity facility.”<sup>190</sup>

The Commission does not agree with this commenter’s conclusion. One purpose of a letter of credit or other liquidity facility for demand securities is to provide liquidity in the event that a new investor is not found at the time the securities are tendered for repurchase. A draw in such a situation does not necessarily reflect financial difficulties “with respect to the securities” of the credit enhancement provider or the obligated person, but may reflect underlying market

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189 Id.

190 Id.



conditions, as evidenced by failed remarketings during 2008 and 2009.<sup>191</sup> In the event of a draw that does not reflect financial difficulties with respect to the securities, a notice would not be provided. A determination regarding the existence of financial difficulties must be made on a case-by-case basis, depending on the facts and circumstances surrounding such draws and failed remarketings.

Finally, one commenter, who supported the deletion of the materiality condition, recommended deleting the phrase “reflecting financial difficulties” for events relating to unscheduled draws on debt-service reserves or credit enhancements.<sup>192</sup> This commenter suggested that, even with the removal of the materiality condition from these event items, the phrase “reflecting financial difficulties” may allow an issuer, in certain circumstances, to make a judgment regarding whether the occurrence of such an event would require disclosure.<sup>193</sup>

Although the Commission continues to believe that the disclosure of unscheduled draws is important to investors and other market participants, the Commission also recognizes that, in some circumstances, such draws are not the result of financial difficulties that would impact the creditworthiness of an issuer or obligated person, or the price of a municipal security. Accordingly, the Commission believes that the phrase “reflecting financial difficulties” should be retained in the Rule at this time.

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<sup>191</sup> See, e.g., Richard Williamson, HOUSING: HFAs Still Facing VR Debt Woes; No Relief Till 2011 Even With U.S. Aid, The Bond Buyer, October 7, 2009; Frank Sulzberger and Andrew Flynn, Lessons From Tough Times: Understanding VRDO Failures, The Bond Buyer, July 21, 2008 (“Until the recent credit crisis, few bonds had ever experienced a remarketing failure and when they did, liquidity providers were able to step in with little risk to their balance sheet. . . . In a normal market, the remarketing agent might step in and buy the tendered bonds, in order to prevent an actual draw on an LOC or credit facility. But this time around, the volume of the tenders and restrictions on their own liquidity made this choice difficult, if not impossible, for many remarketing agents.”)

<sup>192</sup> See Fidelity Letter at 2.

<sup>193</sup> See Fidelity Letter at 2.

c. Substitution of Credit or Liquidity Providers, or Their Failure to Perform

One commenter opposed eliminating the materiality condition from this event, in light of the proposed ten business day frame for submitting event notices to the MSRB.<sup>194</sup> This commenter acknowledged the importance of disclosing this information, but believed that as a result of the recent market turmoil, determining whether the occurrence of this event is material as a condition to providing notice remains important.<sup>195</sup>

The Commission believes that the identity of credit or liquidity providers and their ability to perform is important information for investors.<sup>196</sup> The Commission understands that credit ratings of municipal securities are typically based on the higher of the obligor's rating or the rating of the credit provider<sup>197</sup> and that, with occasional exceptions, credit enhancement is obtained from a credit provider with a higher rating than that of the obligor. When a credit enhancer such as a bond insurer is downgraded, the market value and the liquidity of the

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<sup>194</sup> See GFOA Letter at 4. The commenter expressed concern about the removal of materiality condition in the context of the ten business day time frame. As the Commission noted earlier in this release, the events contained in paragraph (b)(5)(i)(C) of the Rule, which includes the substitution of credit or liquidity providers, or their failure to perform, are significant events that an issuer should become aware of within a very short period of time. See *supra* Section III.B.

<sup>195</sup> See GFOA Letter at 4.

<sup>196</sup> Two commenters recommended that the event notice pertaining to substitution of credit or liquidity providers or their failure to perform should be expanded to include any renewal, or modification, of any credit or liquidity facility or other agreements supporting or otherwise material to a municipal security. See ICI Letter at 8 and Fidelity Letter at 3. These commenters noted that changes to, or violations of, any of the credit or liquidity agreements pertaining to a municipal security can modify the security, thereby causing a mandatory tender event or impacting the prospects for its remarketing. In their view, these events can have significant implications for investors. The Commission, in this rulemaking, is taking a targeted approach at this time. The Commission will take these comments into account should it consider further improvements that could be made to the Rule.

<sup>197</sup> See, e.g., Proposing Release, *supra* note 2, 74 FR at 36839, n. 80.

securities that it has enhanced generally decline.<sup>198</sup> Similarly, the identity and ability of a liquidity provider to perform typically is critical to investors. Investors in demand securities, for example, depend on liquidity providers to satisfy holders' right to tender their securities for repurchase in a timely manner. Furthermore, substitution of credit or liquidity providers requires direct involvement of an issuer or obligated person.<sup>199</sup> Thus, an issuer or obligated person would be aware of the impending occurrence of such an event and should be able to provide notice of the event within the ten business day time frame. As a result, the Commission believes that notice of substitution of credit or liquidity providers, or their failure to perform, should always be provided to aid investors in making investment decisions and protecting themselves from fraud and to assist brokers, dealers and municipal securities dealers in satisfying their obligation to have a reasonable basis to recommend municipal securities.

d. Defeasances

One commenter expressly favored maintaining the materiality condition for notice of defeasances.<sup>200</sup> This commenter believed that removal of the materiality condition "would require notice of defeasances of securities regardless of how short the remaining term of the securities, and therefore would require an issuer to give notice whenever it creates a thirty-day or

<sup>198</sup> See, e.g., Proposing Release, supra note 2, 74 FR at 36839, n. 81.

<sup>199</sup> See, e.g., Richard Williamson, Houston Metro Seeks LOC for Light Rail, The Bond Buyer, April 16, 2008; and Elizabeth Carvlin, Trends in the Region: Bond Contracts Stand at Center of Detroit Airport Dispute, The Bond Buyer, September 11, 2002.

<sup>200</sup> See NABL Letter at 7. A defeasance typically is understood as the termination of the rights and interests of the bondholders and of their lien on the pledged revenues or other security in accordance with the terms of the bond contract for an issue of securities. See, e.g., the MSRB's definition of defeasance at [http://www.msrb.org/msrb1/glossary/glossary\\_db.asp?sel=d](http://www.msrb.org/msrb1/glossary/glossary_db.asp?sel=d).

shorter escrow for refunded bonds in order to avoid giving notice of redemption before an issue of refunding bonds is closed.”<sup>201</sup>

Typically, because defeased municipal securities are secured by escrows of cash, or Treasury securities, sufficient to pay principal and interest to maturity or the appropriate call date, the value of municipal securities increases significantly when they are defeased. Information about such changes in the value of municipal securities – positive as well as negative – is important to investors in making investment decisions, such as whether to sell their securities prior to the defeasance date and, if so, whether the sale price is appropriate. Also, notice of a defeasance should reduce the likelihood that investors will be subject to fraud facilitated by inadequate disclosure, by providing them with information concerning the defeasance so that they can better assess the value of their defeased municipal securities. Further, the Commission is of the view that, regardless of the length of the escrow period, notice of defeasance is justified, because of the significance of the event and because investors should be provided sufficient time to plan the re-investment of their funds. Consequently, the Commission believes that notice of defeasance should not be subject to a materiality condition and should be provided to the MSRB in each instance.

e. Rating Changes<sup>202</sup>

One commenter recommended that the term “rating change” should be defined if the materiality condition is removed from this event item.<sup>203</sup> The commenter suggested that the Rule should be limited to those changes, for which the issuer or obligated person has actual

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<sup>201</sup> See NABL Letter at 7.

<sup>202</sup> See also supra Section III.B. for a discussion of rating changes in the context of the ten business day time frame.

<sup>203</sup> See Kutak Letter at 3-4.

knowledge, in the highest published rating relating to a given security, whether the underlying rating or the credit-enhanced rating.<sup>204</sup> The commenter also stated that the term “rating change” should exclude changes in outlook, as well as changes in credit ratings of parties other than the issuer or obligated person, unless the issuer or obligated person has received specific notice of the change in such other party’s rating.<sup>205</sup> Some commenters argued that the proposed deletion of the materiality condition for this event item, together with the ten business day time frame to submit event notices to the MSRB, would create a substantially larger burden for issuers.<sup>206</sup> The same commenters believed that rating changes should be removed from the list of disclosure events in the Rule entirely, and that rating organizations should be responsible for providing this information directly to the MSRB.<sup>207</sup>

The Commission notes that, as a practical matter, changes in credit ratings today are likely to impact the price of municipal securities, and thus investors in these securities, as well as market professionals, analysts, and others, should have access to this information.<sup>208</sup> As discussed earlier, the continuing disclosure agreements that issuers have entered into pursuant to Participating Underwriters’ obligations under the Rule already require them to submit event notices to the MSRB for rating changes, if material. The Commission acknowledges that removal of the materiality condition may increase the number of event notices submitted in

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Id.

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Id.

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See Halgren Letter, Los Angeles Letter at 1-2, NAHEFFA Letter at 2-4, San Diego Letter at 1-2, California Letter at 1-2, NABL Letter at 8, and GFOA Letter at 3-4.

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See supra note 153 and accompanying text.

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The Commission recently adopted amendments to its rules and forms, and is considering other amendments, to remove certain references to credit ratings by nationally recognized statistical rating organizations, in order to discourage undue investor reliance on them. See, e.g., Securities Exchange Act Release Nos. 58070 (July 1, 2008), 73 FR 40088 (July 11, 2008), and 60789 (October 5, 2009), 74 FR 52358 (October 9, 2009).

connection with rating changes.<sup>209</sup> However, the removal of the materiality condition from this event item will simplify the submission of event notices for ratings changes by removing the burden on issuers to make a determination as to whether or not such a change is material and thus requires submission of a event notice. The Commission notes that rating agencies typically indicate a rating change by changing the widely understood symbols used to indicate rating categories, which should make a determination of the occurrence of a rating change very straightforward.<sup>210</sup> Under the amendments, a notice of a rating change by any rating agency would be included even if another rating agency has not revised its rating of the municipal security.

Three commenters argued that information about rating changes is already accessible to investors through the media or Internet.<sup>211</sup> In the Commission's view, investors would benefit from being able to access a central source to determine whether there has been a rating change with respect to a particular municipal security, rather than relying on the media or accessing each rating organization's Internet Web site. Two of these commenters suggested a limited exemption from the Rule for rating changes involving municipal securities that are the result of rating changes involving the bond insurer or credit enhancer.<sup>212</sup> The Commission does not believe that an exemption for bond insurers and credit enhancers from the Rule is appropriate. As discussed

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<sup>209</sup> See *infra* Section V.D. for discussion of the paperwork burden in connection with deletion of materiality condition.

<sup>210</sup> Ratings are expressed as letter grades that range, for example, from 'AAA' to 'D', and may include modifiers such as +, -, or numbers (e.g., 1, 2, 3) to communicate the agency's opinion of relative level of credit risk. See, e.g., <http://www.moodys.com/>, <http://www.standardandpoors.com/> and <http://www.fitchratings.com/>. For purposes of Rule 15c2-12, "ratings change" does not include indicators of an increased likelihood of an impending ratings change, such as "negative credit watch."

<sup>211</sup> See Portland Letter at 2, San Diego Letter at 2, and California Letter at 3.

<sup>212</sup> See Portland Letter at 2 and California Letter at 3.

above, ratings for particular securities generally reflect the rating of the provider of credit enhancement, if any, in addition to the obligated person (or other source of payment).<sup>213</sup> If a credit-enhanced municipal bond is downgraded because of a rating change involving the bond insurer or credit enhancer, that is likely to impact the price of the security and is important information that should be disclosed to investors.

### 3. Retention of Materiality Condition for Specified Events

Finally, the Commission is adopting, as proposed, amendments to paragraph (b)(5)(i)(C) and subparagraphs (2), (7), (8), and (10) thereunder with regard to the Participating Underwriter's obligations by specifying that a materiality determination is retained for event notices regarding (1) non-payment related defaults; (2) modifications to rights of security holders; (3) bond calls; and (4) the release, substitution, or sale of property securing repayment of the securities.

Two commenters opposed retaining the materiality condition for notice of non-payment related defaults and for bond calls, which currently are set forth in paragraphs (b)(5)(i)(C)(2) and (8) of the Rule, respectively.<sup>214</sup> These commenters remarked that violation of a legal covenant is an important component of an investor's analysis of a bond; disclosure of such events should not be discretionary; and bond calls are always material to investors.<sup>215</sup>

The Commission believes that a materiality condition should be retained for notice of non-payment related defaults and bond calls, respectively. Regularly scheduled sinking fund redemptions (a type of bond call) that occur when scheduled, for example, are ordinary course

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<sup>213</sup> See supra Section III.C.2.b.

<sup>214</sup> See ICI Letter at 8 and Fidelity Letter at 3.

<sup>215</sup> Id.

events that typically are known to bondholders.<sup>216</sup> For such redemptions, the specific amounts to be redeemed and dates for such redemptions generally are included in official statements and usually this information will not be material to investors as they are already apprised of the occurrence of such redemptions in advance. The occurrence of other kinds of calls, such as optional calls and extraordinary calls, however, generally is not known to bondholders in advance. These typically are important events for investors because they may directly affect the value of the municipal security. Thus, such calls may be material and would need to be disclosed.

With respect to non-payment related defaults, under some circumstances, the occurrence of such defaults may not rise to the level of importance that they would need always to be disclosed to investors. For example, failure to comply with loan covenants to deliver updated insurance binders to the trustee or to take other ministerial actions by an annual deadline, if not cured within the period provided for in the loan documents, may constitute events of default, but such defaults may not be material to investors. On the other hand, failure to comply with covenants to maintain certain financial ratios or cash on hand, for example, may be of great importance to investors as they may be early warnings of a decline in the operations or financial condition of the issuer or obligated person. The Commission believes that this materiality determination is similarly appropriate in the context of modifications of rights of security holders and the release, substitution, or sale of property securing repayment of the securities. Accordingly, the Commission continues to believe that information about the four events for

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<sup>216</sup> The fact that a security may be redeemed prior to maturity in whole, in part, or in extraordinary circumstances is essential to an investor's investment decision about the security and is one of the facts a broker-dealer must disclose at the time of trade. See MSRB Interpretative Notice Concerning Disclosure of Call Information to Customers of Municipal Securities, MSRB, March 4, 1986.



which the materiality condition is retained is not necessarily important to investors and other market participants in all instances, and thus the Commission is retaining the materiality condition for these events.

D. Amendment Relating to Event Notices Regarding Adverse Tax Events under a Continuing Disclosure Agreement

Currently, paragraph (b)(5)(i)(C)(6) of the Rule pertains to “adverse tax opinions or events affecting the tax-exempt status of the security.” The Commission is adopting, with certain modifications from that proposed, an amendment to paragraph (b)(5)(i)(C)(6) of the Rule to require that Participating Underwriters reasonably determine that the issuer or obligated person has entered into a continuing disclosure agreement to submit a notice for “[a]dverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security.” As discussed below, in adopting this amendment, the Commission is making certain changes to the text of the amendment from that which was proposed<sup>217</sup> to clarify the use of the word “material” in this event item and to replace the phrase “tax-exempt status” with “tax status” to focus the disclosure on information relevant to investors, whether the municipal security is taxable or tax-exempt.

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<sup>217</sup> In the Proposing Release, the Commission proposed modifying paragraph (b)(5)(i)(C)(6) of the Rule so that continuing disclosure agreements would provide for the submission of a notice for “[a]dverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax-exempt status of the securities, or other events affecting the tax-exempt status of the security.” See Proposing Release, supra note 2, 74 FR at 36868.

Four commenters expressed support for the proposed modifications to the list of adverse tax events included in the Proposing Release.<sup>218</sup> One of these commenters noted that investors have a strong interest in being informed of actions taken by the IRS that present a material risk to the tax-exempt status of their holdings.<sup>219</sup> Several other commenters expressed concerns regarding the proposed items to be added to the disclosure for adverse tax events, particularly in light of the proposed removal of the materiality condition from this provision.<sup>220</sup> One commenter recommended that the materiality condition be retained for all items in paragraph (b)(5)(i)(C)(6) of the Rule, other than a final determination of taxability.<sup>221</sup> Other commenters, however, stated that the materiality condition should be retained for notice of all tax-related events.<sup>222</sup> One commenter noted that the municipal market may be flooded with notices due to the generality and vagueness of the proposed tax disclosure items.<sup>223</sup> This commenter further remarked that this provision will result in a “flood of notices” that could confuse and mislead investors, result in liquidations of municipal securities by multiple sellers simultaneously, or desensitize the market to such notices.<sup>224</sup>

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<sup>218</sup> See SIFMA Letter at 3, NFMA Letter at 2, San Diego Letter at 2, and California Letter at 2.

<sup>219</sup> See SIFMA Letter at 3.

<sup>220</sup> See NABL Letter, Metro Water Letter, Connecticut Letter, Kutak Letter, and GFOA Letter.

<sup>221</sup> See NABL Letter at 7.

<sup>222</sup> See Metro Water Letter at 3, Connecticut Letter at 2, Kutak Letter at 4-7, and GFOA Letter at 4.

<sup>223</sup> See Kutak Letter at 4-7.

<sup>224</sup> Id.

In addition, three commenters expressed concerns about the impact of the disclosure of event notices during the IRS's audit process.<sup>225</sup> One commenter believed that an issuer's disclosure of event notices during the audit process could cause its bonds to be viewed unfavorably in the market and thus could result in higher borrowing costs for the issuer.<sup>226</sup> Another commenter noted that disclosure of a pending audit "would have adverse consequences to the issuer long before the IRS finally determines whether any tax code violations actually have occurred,"<sup>227</sup> while a third commenter indicated that disclosure of an audit would "confuse investors who may not be well versed in the IRS audit process."<sup>228</sup>

The Commission previously has noted that "an 'event' affecting the tax-exempt status of a security may include the commencement of litigation and other legal proceedings, including an audit by the Internal Revenue Service . . . ."<sup>229</sup> While the Commission continues to believe that "an event affecting the tax-exempt status of the security" can include an audit (and thus an audit should be the subject of an event notice when it is material), it agrees with the comment that not all audits indicate a risk to the security's tax status. At times, IRS staff conducts audits as part of project initiatives where it is not examining a specific problem or bond issue.<sup>230</sup> On the other hand, some audits are targeted to examining specific bonds when, for example, IRS staff has received information from the public that has raised IRS staff concern.<sup>231</sup> Thus, a determination

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<sup>225</sup> See Kutak Letter at 5, GFOA Letter at 4, and Metro Water Letter at 3.

<sup>226</sup> See Kutak Letter at 5.

<sup>227</sup> See Metro Water Letter at 3.

<sup>228</sup> See GFOA Letter at 4.

<sup>229</sup> See 1994 Amendments Adopting Release, *supra* note 8, 59 FR at 59600. See also Proposing Release, *supra* note 2 74 FR at 36840.

<sup>230</sup> See, e.g., IRS FY 2010 Tax-Exempt Bonds Work Plan, IRS (available at [https://www.irs.gov/pub/irs-tege/fy\\_2010\\_teb\\_workplan.pdf](https://www.irs.gov/pub/irs-tege/fy_2010_teb_workplan.pdf)).

<sup>231</sup> Id.

by the issuer or obligated person in possession of the facts concerning the audit of a particular bond issue regarding whether a particular audit is material (and, thus, is an “other material event affecting the tax status of the security”) is appropriate. In contrast, proposed and final determinations of taxability and Notices of Proposed Issue, which are determinations by the IRS that the IRS believes that a security is or may be taxable and has begun a formal administrative process in that regard, suggests that there could be a significant risk to the tax status of that security.<sup>232</sup> Accordingly, the Commission believes that proposed and final determinations of taxability and Notices of Proposed Issue are of such importance to investors that they always should be disclosed pursuant to a continuing disclosure agreement.

Retail and institutional investors consider the tax status of a municipal security, specifically the issuance of IRS notices, to be of great importance when making the decision to invest in tax-exempt bonds as opposed to other fixed-income securities.<sup>233</sup> This is a view supported by several commenters.<sup>234</sup> The financial significance of the municipal security’s tax-exempt status is reflected directly in the interest rate on a tax-exempt municipal bond, which generally is significantly lower than the interest rate on a comparable taxable bond.<sup>235</sup> Accordingly, investors are particularly sensitive to factors that could affect the tax-exempt status of interest earned on their municipal securities, because that status goes directly to the value of

<sup>232</sup> See Proposing Release, *supra* note 2, 74 FR at 36841.

<sup>233</sup> See Proposing Release, *supra* note 2, 74 FR at 36841, n. 89.

<sup>234</sup> See NFMA Letter at 2 and SIFMA Letter at 3. See also California Letter at 2, and San Diego Letter at 2.

<sup>235</sup> See, e.g., SIFMA, “About Municipal Bonds – The Advantages of Tax Exemption,” available at: <http://www.investinginbonds.com/learnmore.asp?catid=8&subcatid=53&id=233>; Morgan Stanley Smith Barney, “Tax-Free Municipal Bonds - Frequently Asked Questions,” (question 4. Why is it better for me to own municipals when municipal bond rates are lower than taxable bond (Treasury bonds, corporate bonds) rates?), available at: <http://www.morganstanleyir.dividual.com/markets/bondcenter/school/faq/default.asp#4>.

their investment.<sup>236</sup> Further, a determination by the IRS staff that interest on a security purchased as tax-exempt may, in fact, be taxable may not only reduce the security's market value, but also may adversely affect each investor's federal and, in some cases, state income tax liability.<sup>237</sup> A security's tax-exempt status is also important to many mutual funds whose governing documents, with certain exceptions, limit their investment to tax-exempt municipal securities.<sup>238</sup> Mutual funds may liquidate securities that become taxable, which could have adverse consequences for the fund and its holders and could cause adverse effects if many holders attempt at the same time to liquidate similar securities, which at times could be illiquid. Therefore, retail and institutional investors alike are very interested in events that could adversely affect the tax status of the bonds that they own or may wish to purchase.

Moreover, as the Commission noted in the Proposing Release, despite the possibility that the issuance of proposed and final determinations of taxability and Notices of Proposed Issue could adversely affect the tax-exempt status of a bond and thus could significantly affect the pricing of such municipal security,<sup>239</sup> it has been reported that notices regarding such tax events are not always submitted.<sup>240</sup> The Commission believes that the issuance of proposed and final

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<sup>236</sup> See Proposing Release, supra note 2, 74 FR at 36841, n. 90.

<sup>237</sup> For example, investors in such a circumstance may have to include interest on such a security as income when computing their federal income taxes for current and future tax years and may have to pay additional taxes for prior tax years. See Proposing Release, supra note 2, 74 FR at 36841.

<sup>238</sup> See Proposing Release, supra note 2, 74 FR at 36841, n. 92.

<sup>239</sup> See Proposing Release, supra note 2, 74 FR at 36842, n. 100.

<sup>240</sup> See Proposing Release, supra note 2, 74 FR at 36842, n. 101. See, e.g., Susanna Duff Barnett, IRS Answers Toxic Query; Post 1986 Radioactive Waste Debt Not Exempt, The Bond Buyer, November 2, 2004 (material event notice filed October 29, 2004 regarding IRS technical advice memorandum dated August 27, 2004 that bonds issued to finance certain radioactive solid waste facilities were taxable; related preliminary adverse determination letter was issued in January, 2002). See also supra note 140.

determinations of taxability and Notices of Proposed Issue by the IRS are important information that should be made available to investors and, accordingly, should be part of the continuing disclosure agreement obtained by a Participating Underwriter. The Commission believes that the IRS has issued a relatively small number of such determinations with respect to municipal securities when considered in light of the size of this market sector.<sup>241</sup> As a result, few issuers or obligated persons should be affected by adding proposed and final determinations of taxability and Notices of Proposed Issue to this event item. One commenter noted that disclosure of the issuance of proposed or final determinations of taxability and of material audits often results in a higher interest rate for VRDOs, resulting in an increased cost to the issuer.<sup>242</sup> That change in the interest rate supports the view that investors place a high degree of importance on events that may impact the tax status of their bonds. Thus, the Commission believes that disclosure in all instances of proposed and final determinations of taxability, Notices of Proposed Issue, and other material events affecting the tax status of a security, such as material audits, would help apprise investors of important information with respect to these securities.

Two commenters expressed specific concerns regarding the deletion of the materiality condition for submission of notices relating to adverse tax events.<sup>243</sup> One commenter believed that submitting a notice for all proposed tax determinations could limit the issuer's ability to negotiate with the IRS.<sup>244</sup> Another commenter remarked that without a materiality condition, disclosure of adverse tax events may mislead and confuse investors and could affect perceptions

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<sup>241</sup> See Proposing Release, *supra* note 2, 74 FR at 36853, which notes that for Paperwork Reduction Act purposes, 130 event notices relating adverse tax events, including IRS determinations, are estimated to be submitted to the MSRB.

<sup>242</sup> See Kutak Letter at 5.

<sup>243</sup> See Metro Water Letter at 3 and Kutak Letter at 4-7.

<sup>244</sup> See Metro Water Letter at 3.

with respect to all of the issuer's securities, imposing interest and other costs that could limit future market access.<sup>245</sup> Other commenters, however, supported the proposed deletion of the materiality condition.<sup>246</sup>

As noted above, the Commission disagrees that disclosure of adverse tax events would "unnecessarily alarm investors," as one commenter argued.<sup>247</sup> Because investors place a high degree of importance on the tax status of their municipal securities, and the tax status of a security significantly affects the market price of a security, the Commission believes that disclosing a potential threat to that status is necessary and that investors have a keen interest in being informed of such events. Furthermore, the Commission believes that the failure to disclose adverse tax events potentially could mislead investors who would have no reason to know or other means to discover that the tax status of their bonds may be in doubt and the market value of those securities may be at risk.

One commenter noted that the text of the amendment in the Proposing Release included a materiality condition for one provision that impliedly applies to other provisions of paragraph (b)(5)(i)(C)(6) of the Rule.<sup>248</sup> This commenter suggested that the Commission clarify that the materiality condition applies to all tax events, except for a final determination of taxability.<sup>249</sup> As discussed above, the Commission does not believe that it is appropriate to provide for a materiality condition in the case of proposed or final IRS determinations of taxability. In the Commission's view, these IRS determinations are of such importance to investors that they

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<sup>245</sup> See Kutak Rock Letter at 4-7.

<sup>246</sup> See ICI Letter at 2, NFMA Letter at 2 and SIFMA Letter at 3.

<sup>247</sup> See Connecticut Letter at 2.

<sup>248</sup> See SIFMA Letter at 3.

<sup>249</sup> Id.

always should be disclosed. However, in response to this commenter's recommendation, the Commission is revising the amendment to paragraph (b)(5)(i)(C)(6) from that proposed to clarify its original intention that the event item pertains to "other material events affecting the tax status of the security" (emphasis added). The Commission agrees with the commenter that it would be appropriate to clarify this phrase so that notices of events not specified in the Rule that affect the tax status of a security are required only if these events are material to investors.

Finally, in February 2009, Congress enacted the American Recovery and Reinvestment Act of 2009 ("ARRA"),<sup>250</sup> which authorized the issuance of Build America Bonds and other taxable municipal bonds with associated tax credits or direct federal payments to the issuer (collectively, "ARRA Bonds").<sup>251</sup> Because ARRA Bonds are municipal securities, Participating Underwriters would need to comply with the Rule's provisions, including paragraph (b)(5)(i)(C), when these bonds are the subject of a primary offering. Thus, a Participating Underwriter will be required to reasonably determine that an issuer or an obligated person has entered into a continuing disclosure agreement to submit continuing disclosure documents to the MSRB.

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<sup>250</sup> P.L. 111-5, 123 Stat. 115 (2009).

<sup>251</sup> The American Recovery and Reinvestment Act of 2009 introduced three new categories of tax-advantaged taxable bonds - Build America Bonds (I.R.C. § 54AA), Qualified School Construction Bonds (I.R.C. § 54F), and Recovery Zone Economic Development Bonds (I.R.C. §§ 1400U-2). In addition, the ARRA expanded the authority to issue taxable New Clean Renewable Energy Bonds (I.R.C. § 54C), Qualified Energy Conservation Bonds (I.R.C. § 54D) and Qualified Zone Academy Bonds (I.R.C. § 54E). This followed the introduction of taxable Qualified Forestry Conservation Bonds (I.R.C. § 54B) in the Heartland, Habitat, Harvest, and Horticulture Act of 2008. Taxpayers who hold such bonds on a "credit allowance date" generally are allowed a specified credit against their federal income tax liability (with the notable exceptions being Build America Bonds for which the issuer has elected to receive payments from the U.S. Treasury under I.R.C. § 54AA(g)(1), referred to herein as "Direct-Pay BABs," and Recovery Zone Economic Development Bonds). In addition, the tax credits may be "stripped" from the underlying taxable bonds (see I.R.C. §§ 54A(i), 54AA(f)(2)), either by the issuer or by a holder in the secondary market, and sold to different investors pursuant to Treasury Department regulations to be issued.



ARRA Bonds are required to comply with many of the same provisions of the Internal Revenue Code as are tax-exempt bonds, such as restrictions on arbitrage.<sup>252</sup> The benefits granted to ARRA Bonds (e.g., tax credits and related federal payments to issuers) are only authorized for bonds that comply with the provisions of the Internal Revenue Code that grant these benefits.<sup>253</sup> Furthermore, like tax-exempt municipal bonds, adverse tax opinions, proposed or final determinations of taxability, Notices of Proposed Issue, or other material notices or determinations by the IRS with respect to the tax status of the securities, or other material events affecting the tax status of the security, may be applicable to ARRA Bonds. To clarify the applicability of paragraph (b)(5)(i)(C)(6) of the Rule, as amended, to ARRA Bonds, the Commission is adopting, for purposes of this paragraph, the phrase “tax status,” rather than “tax-exempt status,” of the security. The Commission believes that this limited change will clarify that Participating Underwriters of ARRA Bonds are required to reasonably determine that issuers or obligated persons of such bonds have entered into a continuing disclosure agreement to submit to the MSRB, among other things, the tax-related disclosure events included in paragraph (b)(5)(i)(C)(6) of the Rule. For investors who hold ARRA Bonds with associated tax credits, the consequence of an issuer’s failure to comply with the applicable requirements of the Internal Revenue Code is the loss of the benefit of a tax credit.<sup>254</sup> For investors who hold tax-exempt municipal securities, the consequence of an issuer’s failure to comply with federal tax provisions

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<sup>252</sup> See, e.g., Section 54AA of ARRA (Build America Bonds); I.R.C. § 1400U-2(b) (Recovery Zone Economic Development Bonds); I.R.C. §§ 54A and 54C (New Clean Renewable Energy Bonds); IRC sections 54A and 54C (Qualified Energy Conservation Bonds); I.R.C. §§ 54A and 54E (Qualified Zone Academy Bonds); I.R.C. §§ 54A and 54F (Qualified School Construction Bonds). See also, IRS Notice 2009-26 - Build America Bonds and Direct Payment Subsidy Implementation.

<sup>253</sup> See P.L. 111-5, 123 Stat. 115 (2009).

<sup>254</sup> See, e.g., I.R.C. §§ 54A and 54AA.

is the loss of the benefit of tax-exempt interest income. In the Commission's view, the consequences to investors who hold either ARRA bonds or tax-exempt municipal securities are comparable. Therefore, the Commission believes that this minor revision to this disclosure event will allow investors in ARRA Bonds, like investors in tax-exempt bonds, to have timely access to important information concerning risks that may affect the tax status of their securities.

E. Addition of Events to be Disclosed under a Continuing Disclosure Agreement

The Commission is adopting, as proposed, the amendments adding four new events to paragraph (b)(5)(i)(C) of the Rule. These additional events are: (1) tender offers; (2) bankruptcy, insolvency, receivership, or similar proceeding of the obligated person; (3) the consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material; and (4) appointment of a successor or additional trustee, or the change of name of a trustee, if material. The Commission believes that the amendments relating to submission of events that are added to the Rule are justified by the transparency benefits that will result to investors, broker-dealers, analysts, and others.

1. Tender Offers

The Commission is adopting, as proposed, the amendment to add tender offers to the list of events in paragraph (b)(5)(i)(C)(8) of the Rule.<sup>255</sup> Under the amendment, a Participating

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<sup>255</sup> In passing the Williams Act, P.L. 90-439, in 1968, Congress recognized that regulation of tender offers was necessary for the purposes of disclosure of material information and substantive protection to investors. See Rep. No. 550, 90th Cong., 1st Sess. 3 (1967) at 1. Municipal securities, however, generally are not subject to Commission rules governing tender offers, including rules that set forth disclosure, time periods, and other requirements governing tender offers by issuers.

Underwriter must reasonably determine that the issuer or obligated person has agreed in its continuing disclosure agreement to provide notice of tender offers to the MSRB. A number of commenters supported the addition of this event item.<sup>256</sup> Two commenters stated that notice of a tender offer will provide meaningful information regarding a particular bond.<sup>257</sup>

Some commenters, while supporting the amendment to add tender offers, recommended modifying this disclosure event. One commenter noted that it is not uncommon for tender offers to be made only to select municipal security holders.<sup>258</sup> This commenter stated that, in this instance, there is no reason to inform other security holders of a limited tender offer, unless the offer would have a material impact on those holders.<sup>259</sup> Accordingly, the commenter recommended restricting notice to only those tender offers made to all holders.<sup>260</sup> Further, this commenter and three other commenters suggested that the Commission add a materiality qualifier to the provision.<sup>261</sup>

The Commission continues to believe that notice of the occurrence of any tender offer should be made available to all bondholders because this information is important to an investor's ability to make an informed and timely decision regarding the security that is the subject of the tender offer. Even when tender offers are made to a limited number of bondholders, they may be material to other bondholders' evaluation of their investment. For example, a tender offer may be made to fewer than all bondholders by an obligated person facing

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<sup>256</sup> See ICI Letter at 8, Fidelity Letter at 2, NFMA Letter at 2, and SIFMA Letter at 4.

<sup>257</sup> See ICI Letter at 8 and Fidelity Letter at 2.

<sup>258</sup> See NABL Letter at 7.

<sup>259</sup> Id.

<sup>260</sup> Id.

<sup>261</sup> See Connecticut Letter at 2, GFOA Letter at 4, Metro Water Letter at 2, and NABL Letter at 7.

financial difficulties. In such instance, those holders who are not invited to participate in the tender offer would have the option to consider and react (i.e., buying, selling, or holding such securities) to the information contained in the notice about such a tender offer.<sup>262</sup>

Further, during a tender offer, some investors presently may be left in doubt as to whether their securities are subject to the offer because information about the tender offer is not readily available to them.<sup>263</sup> To determine the facts about a tender offer, it often is necessary for investors to seek pertinent information directly from the issuer or other obligated person. Currently, some investors may not be able to learn of the existence of a tender offer in a timely fashion, which may impair such investors' ability to react to the offer (i.e., buying, selling, holding, and if the offer is available to them, tendering securities).<sup>264</sup> Consequently, the Commission believes that notice of the existence of a tender offer in a timely manner and in any event within ten business days of its occurrence would help to improve the timely availability of tender offer information so that investors would be offered the opportunity to make informed, timely decisions about whether to buy, sell, hold or tender their securities.<sup>265</sup> Furthermore, the

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<sup>262</sup> In addition, two commenters recommended that the Commission provide a definition of "tender offer" for purposes of the Rule. See Kutak Letter at 4 and GFOA Letter at 4. Although the term "tender offer" has not been defined, the Commission notes that the meaning of "tender offer" for municipal securities purposes is no different from the meaning of "tender offer" for other securities subject to the tender offer provisions of the Exchange Act and related rules. See generally Rule 14d-1(g) under the Exchange Act. 17 CFR 240.14d-1(g). One of these commenters also suggested that the tender agent, rather than issuer, should submit the notice to the MSRB. See GFOA Letter at 4. The Commission notes, however, that an issuer already may negotiate to designate a tender agent to submit a tender offer notice to the MSRB on its behalf. See 17 CFR 240.15c2-12(b)(5)(i).

<sup>263</sup> See Proposing Release, supra note 2, 74 FR at 36843.

<sup>264</sup> Tender offers typically require an investor to respond within a limited time frame. See Proposing Release, supra note 2, 74 FR at 36843, n. 104.

<sup>265</sup> The amendment retains in Rule 15c2-12(b)(5)(i)(C)(8) the requirement that Participating Underwriters reasonably determine that the issuer or obligated person has agreed in a

Commission believes that such communication provides market participants with relevant information about the offer and should reduce the likelihood that investors will be subject to fraud facilitated by inadequate disclosure.<sup>266</sup>

2. The Occurrence of Bankruptcy, Insolvency, Receivership, or Similar Events Regarding an Issuer or an Obligated Person

The Commission is adopting, as proposed, the amendment to add new paragraph (b)(5)(i)(C)(12) to the Rule, which requires a Participating Underwriter to reasonably determine that an issuer or obligated person has agreed in its continuing disclosure agreement to provide notice about bankruptcy, insolvency, receivership or a similar event with respect to the issuer or an obligated person. The Commission also is adopting, as proposed,<sup>267</sup> the Note to new paragraph (b)(5)(i)(C)(12), which explains that such an event will be considered to have occurred in the following instances: the appointment of a receiver, fiscal agent or similar officer for an

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continuing disclosure agreement to provide to the MSRB notice of bond calls, if material. See *supra* Section III.C.3. Thus, unlike with respect to tender offers, the issuer will be able to make a materiality determination with respect to submitting a notice regarding a bond call. The Commission believes that this distinction is appropriate in light of the various types of bond calls (e.g., sinking fund redemptions, extraordinary redemptions, and optional redemptions) that can occur. In addition, the specific amounts to be redeemed and dates for some redemptions (e.g., sinking fund redemptions) are generally included in official statements. Therefore, information about such events should already be available to investors. Similar information regarding tender offers is not currently as readily available to investors.

<sup>266</sup> The recent events in the market for ARS illustrate the need to provide timely notice (i.e., within ten business days) of the occurrence of a tender offer. Since approximately mid-February of 2008, the market for ARS has experienced severe illiquidity, with adverse consequences to investors who purchased what they may have believed to be liquid, cash equivalent investments. In response, some issuers and obligated persons offered to purchase some or all of their outstanding ARS from investors. See *Proposing Release, supra* note 2, 74 FR at 36843, n. 107. Notices about these tender offers, however, may not always be widely disseminated. See *Proposing Release, supra* note 2, 74 FR at 36843, n. 107.

<sup>267</sup> The Commission is correcting a typographical error in the Note to state “plan of reorganization” rather than “plan or reorganization.”

obligated person in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state or federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the issuer or obligated person, or if such jurisdiction has been assumed by leaving the existing governing body and officials or officers in possession but subject to the supervision and orders of a court or governmental authority, or the entry of an order confirming a plan of reorganization, arrangement or liquidation by a court or governmental authority having supervision or jurisdiction over substantially all of the assets or business of the obligated person.<sup>268</sup> Most commenters supported the addition of bankruptcy to the list of disclosure events.<sup>269</sup>

As the Commission noted in the Proposing Release, although municipal issuers and obligated persons are rarely involved in bankruptcy, insolvency, receivership, or similar events, the occurrence of these events can significantly impact the value of the municipal securities.<sup>270</sup>

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<sup>268</sup> See Form 8-K, Item 1.03 for provisions relating to bankruptcy or receivership that are applicable to entities subject to Exchange Act reporting requirements. 17 CFR 249.308. Item 1.03 of Form 8-K requires the registrant to provide specified items of disclosure on Form 8-K if a receiver, fiscal agent, or similar officer has been appointed for a registrant or its parent, in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state and federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the registrant or its parent, or if such jurisdiction has been assumed by leaving the existing directors and officers in possession but subject to the supervision and orders of a court or governmental authority. The proposed Rule 15c2-12 event item is intended to be consistent with the Form 8-K, Item 1.03 provisions applicable to entities subject to the reporting requirements of the Exchange Act. See also Proposing Release, *supra* note 2, 74 FR at 36844.

<sup>269</sup> See GFOA Letter at 4, NFMA Letter at 2, Connecticut Letter at 2, ICI Letter at 8, Fidelity Letter at 2, NABL Letter at 8, California Letter at 2, and San Diego Letter at 2.

<sup>270</sup> See Proposing Release, *supra* note 2, 74 FR at 36844. Under paragraph (b)(5)(i)(C)(2) of the Rule, notice of a material “non-payment related default” is to be provided to the MSRB pursuant to a continuing disclosure agreement. The Commission understands that the governing documents for some municipal securities include bankruptcy, insolvency, receivership, or similar events involving an issuer or obligated person as a “non-payment related default.” See National Association of Bond Lawyers (“NABL”) Form Indenture, dated June 1, 2002 (“NABL Form Indenture”). However, this may not uniformly be the

Thus, information about these events is important to investors and other market participants.<sup>271</sup>

Being informed about the occurrence of these events will allow investors to make informed decisions about whether to buy, sell, or hold the municipal security.<sup>272</sup>

Some commenters, however, opposed the addition of bankruptcy to the list of disclosure events if it was not limited by a materiality condition.<sup>273</sup> One of these commenters also stated that the bankruptcy provision should apply only to those obligated persons covered by paragraph (b)(5)(i)(A) of the Rule (i.e., those obligated persons for whom annual financial information or operating data is presented in the final official statement).<sup>274</sup> This commenter believed that, without such a revision, this disclosure event could result in an obligation to provide a notice with respect to events that are largely irrelevant to the decision to buy, hold, or sell a particular issue of municipal securities.<sup>275</sup> In addition, this commenter believed that issuers or other obligated persons may be required to undertake perpetual due diligence of all obligated persons

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case. This amendment, therefore, will help improve the availability of notice of these events to all investors and market participants.

<sup>271</sup> See Proposing Release, supra note 2, 74 FR at 36844, n. 112.

<sup>272</sup> As the Commission noted in the Proposing Release, it is aware that bonds are often secured by letters of credit, bond insurance, and other forms of credit enhancement that some have argued could reduce the importance of the creditworthiness of an issuer or obligated person. However, the Commission has long been of the view that information regarding obligated persons generally is material to investors in credit-enhanced offerings. See 1989 Adopting Release, supra note 8, 54 FR at 28812 (“The presence of credit enhancements generally would not be a substitute for material disclosure concerning the primary obligor on municipal bonds.”). See also Regulation AB, 17 CFR 229.1100 et seq. The Commission received no comments on these statements.

<sup>273</sup> See Connecticut Letter at 2, GFOA Letter at 4, Metro Water Letter at 2, and NABL Letter at 8.

<sup>274</sup> See NABL Letter at 8-9.

<sup>275</sup> Id.

to determine whether any such events have occurred, including those obligated persons for whom financial or operating data is not included in the final official statement.<sup>276</sup>

The Commission believes that it is unnecessary to include a materiality condition for this event item. Bankruptcies and similar events involving municipal issuers or obligated persons are significant occurrences that are likely to affect the value of a particular security. Investors should be informed about such events so that they can make their own evaluation about the event's importance under the particular facts and circumstances. Moreover, since such bankruptcies and similar events are relatively rare,<sup>277</sup> the Commission believes that the burden on issuers or obligated persons to provide notice will be modest and is justified by the potential significance of these events to investors.

The Commission also does not believe that it is necessary to limit paragraph (b)(5)(i)(C)(12) to obligated persons for whom annual financial information and operating data is included in the final official statement. The Commission believes that there are a variety of methods by which issuers or obligated persons could avoid having to monitor directly the activities of other obligated persons, such as obtaining, at the time of a primary offering, an agreement from obligated persons for whom annual financial information and operating data are not included in the final official statement that they will provide information pertaining to a bankruptcy, insolvency, receivership or similar event to the party responsible for filing event notices.

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<sup>276</sup> Id.

<sup>277</sup> To illustrate, it has been reported that there were 183 municipal bankruptcies from 1980 to early 2007. See Sylvan G. Feldstein, The Handbook of Municipal Bonds, April 25, 2008 (Wiley).



3. Merger, Consolidation, Acquisition, and Sale of All or Substantially All Assets

The Commission is adopting, as proposed, the amendment to add new paragraph (b)(5)(i)(C)(13) to the Rule, which requires a Participating Underwriter to reasonably determine that the continuing disclosure agreement provides for the submission of notice of any of the following events with respect to the securities being offered: the consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material.<sup>278</sup>

A number of commenters supported adding mergers, consolidations, acquisitions and substantial asset sales to the list of disclosure events in paragraph (b)(5)(i)(C) of the Rule.<sup>279</sup> In

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<sup>278</sup> The Commission also notes that reporting companies are required to make disclosures upon the occurrence of similar events. See Items 1.01 and 2.01 of Form 8-K relating to entry into a material definitive agreement and completion of the acquisition or disposition of assets, respectively, which require entities subject to Exchange Act reporting requirements to disclose specified information within four business days of the occurrence of such events. 17 CFR 249.308. Item 1.01 of Form 8-K requires the registrant to provide specified items of disclosure on Form 8-K if the registrant has entered into a material definitive agreement not made in the ordinary course of business of the registrant, or into any amendment of such agreement that is material to the registrant. For purposes of Item 1.01, a “material definitive agreement” means an agreement that provides for obligations that are material to and enforceable against the registrant, or rights that are material to the registrant and enforceable by the registrant against one or more parties to the agreement, in each case whether or not subject to conditions. Item 2.01 of Form 8-K requires the registrant to provide specified items of disclosure on Form 8-K if the registrant or any of its majority-owned subsidiaries has completed the acquisition or disposition of a significant amount of assets, other than in the ordinary course of business.

<sup>279</sup> See Kutak Letter at 4, NFMA Letter at 2, SIFMA Letter at 4, Connecticut Letter, GFOA Letter at 4, ICI Letter at 8-9, and Fidelity Letter at 3. Two of these commenters recommended that this provision also provide for the submission of additional information pertaining to such transactions, including offer prices, changes in offer prices, withdrawal rights, identity of the offeror, the ability of the offeror to finance the

addition, one of these commenters recommended deleting the “ordinary course” and “if material” qualifiers from the proposed rule text, because these transactions “are rarely, if ever, in the “ordinary course of business” or “immaterial.”<sup>280</sup>

The Commission believes that notice of the events specified in this new Rule provision is important information for investors and market participants.<sup>281</sup> While these corporate-type events are believed to be rare among governmental issuers,<sup>282</sup> they are not uncommon for obligated persons, such as health care institutions, other non-profit entities, and for-profit businesses.<sup>283</sup> As the Commission noted in the Proposing Release, these events may signal that a significant change in the obligated person’s corporate structure could occur or has occurred.<sup>284</sup> In such cases, investors reasonably expect to be informed about the identity and financial condition of the obligated person who would be responsible, following the event, for the payment of the subject security.

In addition, the Commission believes that it is appropriate to retain the “ordinary course” and “if material” conditions because some events, such as small acquisitions, may occur occasionally, but have little or no effect on the value of the municipal security or on an investor’s

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offer, conditions of the offer, time frame of the transaction, and manner of tendering securities and method of acceptance. See ICI Letter at 8-9 and Fidelity Letter at 3. The Commission is taking a targeted approach at this time. These suggested modifications would require more detailed disclosures than the Commission intended for purposes of this rulemaking. Nevertheless, some issuers may voluntarily decide to incorporate some or all of this information in an event notice that is submitted pursuant to a continuing disclosure agreement.

<sup>280</sup> See Fidelity Letter at 2.

<sup>281</sup> See *supra* note 271 (suggesting that disclosure information should include information relating to material acquisitions and dispositions).

<sup>282</sup> See Proposing Release, *supra* note 2, 74 FR at 36845, n. 117.

<sup>283</sup> See Proposing Release, *supra* note 2, 74 FR at 36845, n. 118.

<sup>284</sup> See Proposing Release, *supra* note 2, 74 FR at 36845.

decision whether to buy, sell or hold the security. Similarly, some obligated persons, such as large health care or senior living organizations may be permitted under their loan documents to sell small parcels of real estate that are not necessary to their operations or to change the legal structure of one or more of their component entities (such as a single nursing home), if certain covenants are met. Requiring notices to be filed in the case of all such actions or events that occur would impose a burden on such obligated persons, while providing little useful information to investors.

Two commenters opposed adding mergers and acquisitions to the list of disclosure events.<sup>285</sup> They argued that providing notice of a merger or acquisition, particularly for closely-held companies, upon signing of the relevant agreement would be “anti-competitive,” because such agreements often are signed prior to public announcement and are contingent on approval of the municipality and the lender. In their view, such notice could allow competitors to interfere with the transaction’s consummation prior to its closing.<sup>286</sup> However, the Commission believes that competition in the market for corporate control could be enhanced, not reduced, by the possibility of disclosure, creating more open conditions for the sale of privately-held companies. The Commission further notes that parties to mergers and acquisition agreements generally may, subject to legal obligations, include remedies in such agreements that are designed to balance the conflicting interests of the buyer and the seller. As noted in the Proposing Release, the Commission believes that notice of such mergers, consolidations, acquisitions and substantial asset sales, if material, is important to investors in assessing the value of their investments.<sup>287</sup> These transactions may have an impact on the issuer’s or obligated person’s financial condition,

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<sup>285</sup> See CRRC Letter at 5 and WCRRC Letter.

<sup>286</sup> Id.

<sup>287</sup> See also Proposing Release, supra note 2, 74 FR at 36845.

which, in turn, would have an impact on the price of the municipal securities issued by such parties and could change the identity of the obligor itself. Accordingly, the Commission believes that these disclosures are justified in light of the importance of this information to investors.

One commenter noted that the disclosure item pertaining to mergers, consolidations, acquisitions and substantial asset sales should be revised so that it only applies with respect to those obligated persons covered by paragraph (b)(5)(i)(A) of the Rule (i.e., those obligated persons for whom annual financial information or operating data is presented in the final official statement).<sup>288</sup> This commenter believed that issuers or other obligated persons may be required to undertake perpetual due diligence on all obligated persons to determine whether any such events occurred, including those for whom financial or operating data is not included in the final official statement.<sup>289</sup>

Similar to the Commission's discussion in the context of the bankruptcy and insolvency disclosure event, the Commission does not believe that it is appropriate to limit paragraph (b)(5)(i)(C)(13) to obligated persons for whom annual financial information and operating data is presented in the final official statement. The Commission believes that there are a variety of methods by which issuers or obligated persons could avoid having to monitor directly the

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<sup>288</sup> See NABL Letter at 8. This commenter and several other commenters suggested that the Commission add the "if material" qualifier to this event item. See Connecticut Letter at 2, GFOA Letter at 4, Metro Water Letter at 2, and NABL Letter at 7. The Commission points out, however, that new paragraph (b)(5)(i)(C)(13) contains a materiality condition. As the Commission noted in the Proposing Release, it does not believe that all mergers, consolidations, acquisitions, and substantial asset sales are necessarily of sufficient importance that information pertaining to them needs to be made available in every instance. For example, a merger could involve the combination of a shell corporation or a small entity into a very large health care organization that is a conduit borrower. Such mergers generally would not have a significant impact on the business or financial condition of the larger corporation and, under all of the applicable facts and circumstances, generally would not be important to investors. See Proposing Release, supra note 2, 74 FR at 36845. The Commission received no comments on this statement.

<sup>289</sup> See NABL Letter at 8.

activities of other obligated persons, such as obtaining, at the time of a primary offering, an agreement from obligated persons for whom annual financial information and operating data are not included in the final official statement that they will provide information pertaining to a merger, consolidation, acquisition or substantial asset sale to the party responsible for filing event notices. The Commission also notes that a merger, consolidation, acquisition or substantial asset sale involving an obligated person would not trigger an event notice if such transaction by an obligated person does not meet the materiality standard.

4. Successor, Additional, or Change in Trustee

Finally, the Commission is adopting, as proposed, the amendment to add new paragraph (b)(5)(i)(C)(14) to the Rule, which requires that a Participating Underwriter must reasonably determine that the continuing disclosure agreement provides for the submission of notice of an appointment of a successor or additional trustee, or a change of name of a trustee, if material. Most commenters expressed general support for the addition of this event item to the Rule.<sup>290</sup>

Two commenters, however, expressed concern regarding the increased costs and burdens that some issuers would incur to report changes pertaining to trustees within the Rule's ten business day time frame.<sup>291</sup> One of these commenters noted that, "in the case of the small less sophisticated borrower . . . obligors do not have the resources available to track and report on changes in the trustee on a timely basis or to determine the materiality of a name change."<sup>292</sup> The other commenter noted that "turmoil in the banking sector has meant frequent cha[n]ges in trustees," and that "many issuers and obligated persons are not informed of these changes within

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<sup>290</sup> See Connecticut Letter at 2, NFMA Letter at 2, SIFMA Letter at 4, ICI Letter at 8, Fidelity Letter at 3, and GFOA Letter at 4.

<sup>291</sup> See CHEFA Letter at 3 and NAHEFFA Letter at 4.

<sup>292</sup> See CHEFA Letter at 3.

the proposed ten-day time frame, much less in sufficient time to identify the need to file a notice and prepare the relevant notice within such time period.”<sup>293</sup> These commenters recommended either that knowledge of the event rather than the occurrence of the event trigger the time period to disclose the event, or that the trustee disclose the changes directly to the MSRB.<sup>294</sup>

The Commission continues to believe in the importance of an investor’s ability to be informed about material changes in a trustee’s identity, given the significance of trustees for bondholders.<sup>295</sup> A trustee makes critical decisions that impact investors and is under a duty to represent the interests of bondholders. For example, a trustee often must determine whether proposed amendments to the governing documents of the municipal security are permissible without bondholder consent; parity obligations may be issued; security may be released; or a default event has occurred.<sup>296</sup> In addition, a trustee is responsible for sending payments to investors and computing applicable interest rates. In some cases, a trustee may be responsible for taking certain actions at the direction of a designated percentage of bondholders.<sup>297</sup> A trustee also may be responsible for providing information requested by investors. Often, the trustee serves as the issuer’s dissemination agent for continuing disclosures. Although under normal circumstances the identity of the trustee may have little or no influence on a decision to buy or sell a security, bondholders would need to know who to contact, particularly when an issuer or other obligated person may be experiencing financial difficulty. The Commission is currently unaware of any method by which investors, particularly individual investors, have a consistent

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<sup>293</sup> See NAHEFFA Letter at 4.

<sup>294</sup> Id.

<sup>295</sup> See Proposing Release, supra note 2, 74 FR at 36845-46.

<sup>296</sup> See NABL Form Indenture, supra note 270.

<sup>297</sup> Id.

means of obtaining up-to-date information about changes to the identity of the trustee. In the Commission's view, these factors support the need for investors to know the identity of the trustee.

The Commission believes that issuers and other obligated persons could take steps to become aware promptly of any change of trustee or in the name of a trustee by obtaining an agreement from the trustee to provide advance notice of such an event to them, e.g., by having the indenture specify that the trustee will immediately provide this information to the issuer or obligated person.<sup>298</sup> Furthermore, the addition of a substitute or additional trustee generally involves the participation of the issuer.<sup>299</sup> In such an event, the issuer would likely have adequate time to comply with its undertaking to submit notice of a change in trustee event within the requisite ten business day time frame in order for investors to become aware of the identity of the new trustee. Finally, an issuer or other obligated person could elect to designate the trustee as its agent to provide notice of such an event directly to the MSRB.<sup>300</sup>

A few commenters expressed concerns about the inclusion of a materiality condition in this provision.<sup>301</sup> Two commenters noted that small or less sophisticated issuers may have difficulty determining the materiality of a trustee's name change.<sup>302</sup> Another commenter suggested not including the materiality condition because it believed that all trustee changes are material and "it is critical that investors are informed of such changes as their rights are generally

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<sup>298</sup> See infra Section IV., discussing the obligations of underwriters of municipal securities under the antifraud provisions of the federal securities laws, and note 351.

<sup>299</sup> See, e.g., NABL Form Indenture, supra note 270.

<sup>300</sup> Rule 15c2-12(b)(5)(i) permits an issuer or obligated person to provide documents to the MSRB either directly or indirectly through an indenture trustee or a designated agent. See 17 CFR 240.15c2-12(b)(5)(i).

<sup>301</sup> See CHEFA Letter at 3, NAHEFFA Letter at 4, and Fidelity Letter at 3.

<sup>302</sup> See CHEFA Letter at 3 and NAHEFFA Letter at 4.

exercised through the actions of the trustee.”<sup>303</sup> One commenter suggested that the Commission also should require that the event notice include the trustee’s new contact information.<sup>304</sup>

As noted in the Proposing Release, the Commission believes that whether a change involving a trustee is material must be determined through a review of the particular facts and circumstances surrounding such an event.<sup>305</sup> It is possible that a change is so minor that it would not be material. For example, a name change such as “ABC National Bank and Trust Company of XYZ,” to “ABC National Bank and Trust Company” may not be material in the absence of other factors, such as a change of the location at which the trustee can be reached.<sup>306</sup> On the other hand, when a trustee transfers all or part of its trust operations to a different organization, on account of a merger or otherwise, the Commission believes that it is important for a bondholder to be able to determine the identity of the new trustee.

F. Other Comments

Several commenters advocated additional changes to the Rule. Two commenters suggested that the Commission establish a definitive time period within which the delivery of required ongoing financial information should be provided.<sup>307</sup> Some commenters also suggested that the Commission add other disclosure events to the Rule. These events included: (i) long term funding commitments for payments;<sup>308</sup> (ii) potential termination liabilities for an issuer’s

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<sup>303</sup> See Fidelity Letter at 3.

<sup>304</sup> See NFMA Letter at 2. Issuers should consider including the trustee’s updated contact and identification information in any notice regarding a change in the trustee.

<sup>305</sup> See Proposing Release, supra note 2, 74 FR at 36845, n. 122.

<sup>306</sup> The Commission received no comments on this example.

<sup>307</sup> See e-certus Letter I at 9 and Fidelity Letter at 3-4.

<sup>308</sup> See Shalanca Letter at 1.



interest rate swaps;<sup>309</sup> (iii) the creation of any material financial obligation (including contingent obligations);<sup>310</sup> (iv) a “catch all” event subject to a materiality determination;<sup>311</sup> (v) clarification of the tax-exempt status of a bond;<sup>312</sup> (vi) modifications to escrow agreements or escrows;<sup>313</sup> (vii) various events related to swap transactions;<sup>314</sup> (viii) the conversion of bank bonds to a loan or term note;<sup>315</sup> and (ix) the termination of a conditional liquidity facility.<sup>316</sup> Two commenters requested that the Commission provide interpretative guidance clarifying that climate risk disclosure is material information that should be disclosed to bondholders.<sup>317</sup> Finally, one commenter recommended that the Rule should require every continuing disclosure agreement to include language that successor parties will be bound by the terms of the agreement.<sup>318</sup>

Other commenters proffered additional recommendations to improve the municipal securities market in general and its transparency. In this regard, three commenters suggested that the Commission petition Congress to repeal the Tower Amendment, which restricts the Commission from directly imposing disclosure requirements on municipal issuers.<sup>319</sup> One commenter recommended that the Commission establish specific “listing” and “de-listing”

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<sup>309</sup> See Folts Letter at 1.

<sup>310</sup> See ICI Letter at 9 and Fidelity Letter at 3.

<sup>311</sup> Id.

<sup>312</sup> Id.

<sup>313</sup> Id.

<sup>314</sup> See NFMA Letter at 3.

<sup>315</sup> Id.

<sup>316</sup> Id.

<sup>317</sup> See T.R. Rose and Sierra Letter and NRDC Letter.

<sup>318</sup> See Fidelity Letter at 4.

<sup>319</sup> See e-certus Letter 1 at 3, ICI Letter at 10-11, and Fidelity Letter at 3.

conditions for the MSRB's EMMA system.<sup>320</sup> Another commenter suggested creating a 48-hour right of rescission for retail bond buyers to rescind a transaction if the seller has misrepresented information about a particular bond offering.<sup>321</sup> Finally, one commenter suggested the creation of an on-line marketplace for bond dealers and individuals to buy or sell municipal securities.<sup>322</sup>

The Commission welcomes the foregoing views and suggestions to revise Rule 15c2-12 and improve the transparency and other aspects of the market for municipal securities. As evidenced by its adoption of the 2008 Amendments and today's amendments, the Commission is committed to considering proposals to further enhance the scope of municipal market disclosures and their dissemination to investors. Although the Commission, in this rulemaking, is taking a targeted approach at this time, it will consider commenters' views as it continues its efforts to bring greater transparency and other improvements to the municipal securities market.

G. Compliance Date and Transition

The amendments to Rule 15c2-12 will impact only those continuing disclosure agreements that are entered into in connection with primary offerings of municipal securities that are subject to the Rule and that occur on or after the December 1, 2010 compliance date of these amendments. The Commission understands that existing undertakings by issuers and obligated persons that were entered into prior to the compliance date of these amendments do not require a broker, dealer, or municipal securities dealer to reasonably determine that the issuer or other obligated person had agreed to provide notice of specified events in a timely manner not in excess of ten business days of the event's occurrence or include the additional items discussed above that the amendments added to paragraph (b)(5)(i)(C) of the Rule. In addition, such

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<sup>320</sup> See e-certus Letter I at 10.

<sup>321</sup> See Becker Letter.

<sup>322</sup> See Boatwright Letter.

existing undertakings provide for the submission of the events specified in paragraph (b)(5)(i)(C) of the Rule, "if material." Further, a Participating Underwriter in remarketings of demand securities that are outstanding in the form of demand securities on the day preceding the compliance date of these amendments, and that continuously have remained outstanding in the form of demand securities, is not required to reasonably determine that the issuer or other obligated person has entered into a continuing disclosure agreement, as prescribed by the amended Rule. Likewise, in the case of municipal securities subject to a continuing disclosure agreement entered into prior to the compliance date of these amendments, the recommending broker, dealer, or municipal securities dealer will receive notice solely of those events covered by that continuing disclosure agreement, namely, the eleven events specified in the Rule prior to today's amendments. These continuing disclosure agreements do not cover any of the items to be added to the Rule by the amendments. Thus, in the case of continuing disclosure agreements entered into prior to the compliance date of these amendments, it is not necessary for the recommending broker, dealer, or municipal securities dealer to have procedures in place that provide reasonable assurance that it receive prompt notice of the events added to the Rule by these amendments.

The Commission requested comment on the impact of the amendments with respect to brokers, dealers, and municipal securities dealers that recommend the purchase or sale of municipal securities. The Commission received one comment<sup>323</sup> in response to its inquiry regarding the potential effects and implications of existing continuing disclosure agreements having different terms (e.g., lacking the proposed additional events for which notices would be sent to the MSRB and the specified ten business day deadline as discussed above) than

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<sup>323</sup> See Fidelity Letter at 5.

continuing disclosure agreements entered into on or after the compliance date of these amendments. This commenter recommended that the Commission require that each continuing disclosure agreement entered into by an issuer after the compliance date of these amendments should, by its terms, amend all prior continuing disclosure agreements entered into by the issuer to incorporate the new requirements of the amended Rule.<sup>324</sup> The Commission observes that, under the commenter's suggestion, the effect would be to mandate the amendment of existing contracts. The Commission believes that the better course is to apply the amendments to continuing disclosure agreements entered into on or after the compliance date. While the Commission is mindful of the implications of differing disclosure obligations that will occur over time as a result of this decision, this difference should diminish as existing municipal securities mature or are redeemed.

Four commenters concurred with the Commission's proposed compliance date of no earlier than three months after adoption of the amendments.<sup>325</sup> The Commission also received comments suggesting various time frames for the compliance date of the amendments. One commenter recommended a compliance date no later than three months after Commission approval,<sup>326</sup> and another commenter recommended no later than nine months after Commission approval.<sup>327</sup> Two commenters suggested a time frame of no earlier than six months after the adoption of the amendments by the Commission.<sup>328</sup> These two commenters believed that this suggested time frame is necessary to provide issuers, brokers and dealers with sufficient time to

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Id.

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See Kutak Letter, CHEFA Letter, Fidelity Letter at 2, and ICI Letter at 10.

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See NFMA Letter at 3.

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See MSRB Letter at 2.

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See NABL Letter at 10 and GFOA Letter at 5.

familiarize themselves with new amendments to the Rule and to establish processes to comply with the new amendments.<sup>329</sup> In addition, one of these commenters suggested an even further unspecified delay for implementation of the amendments pertaining to demand securities.<sup>330</sup>

The Commission has considered commenters' various recommendations and believes that a compliance date of approximately six months from the date of the Commission's approval of the amendments is appropriate. The Commission believes that this six month period should be sufficient time for the MSRB to make the necessary modifications to its EMMA system, for Participating Underwriters to revise their procedures to comply with the Rule, as revised, and for issuers and obligated persons to become aware of the amendments and plan for their implementation. Accordingly, the Commission is establishing December 1, 2010 as the compliance date of these amendments.

#### **IV. Interpretive Guidance With Respect to Obligations of Participating Underwriters**

The Commission is aware that municipal securities industry participants have expressed concern that some municipal issuers and other obligated persons may not consistently submit continuing disclosure documents, particularly event notices and failure to file notices, in accordance with their undertakings in continuing disclosure agreements.<sup>331</sup> Municipal security holders' access to meaningful information promotes informed investment decision-making about

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<sup>329</sup> Id.

<sup>330</sup> See NABL Letter at 10.

<sup>331</sup> See Proposing Release, supra note 2, 74 FR at 36847. See also the comments of participants at the 2001 SEC Municipal Market Roundtable – Secondary Market Disclosure for the 21st Century, (available at <http://www.sec.gov/info/municipal/roundtables/thirdmuniround.htm>), E-mail from Peter J. Schmitt, CEO, DPC Data Inc., to the Commission, Rule-Comments, dated September 19, 2008, regarding the 2008 Proposed Amendments, and Peter J. Schmitt, Estimating Municipal Securities Continuing Disclosure Compliance: : A Litmus Test Approach (available at <http://www.dpcdata.com/html/about-researchpapers.html>).

whether to buy, sell, or hold municipal securities<sup>332</sup> and better protection against misrepresentation and fraud. Availability of that information also will aid brokers, dealers, and municipal securities dealers in complying with their obligations to have a reasonable basis for recommending municipal securities. In the Commission's view, the flow of municipal securities disclosure to investors and other market participants depends on issuers and obligated persons abiding by their undertakings in continuing disclosure agreements.<sup>333</sup> Accordingly, the Commission emphasizes that it is important for an underwriter in a municipal offering to evaluate carefully the likelihood that the issuer or obligated person will comply on a timely basis with the undertakings it has made.<sup>334</sup>

In prior releases, the Commission set forth its interpretations of the obligations of municipal underwriters under the antifraud provisions of the federal securities laws.<sup>335</sup> The Commission discussed the duty of underwriters to the investing public to have a reasonable basis for recommending any municipal securities and, in fulfilling that obligation, their responsibility to review the issuer's or obligated person's disclosure documents in a professional manner with respect to the accuracy and completeness of statements made in connection with the offering.<sup>336</sup> The Commission today reaffirms its previous interpretations and provides additional guidance

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<sup>332</sup> See, e.g., 2008 Amendments Adopting Release, supra note 8, 73 FR at 76129.

<sup>333</sup> See 1994 Amendments Adopting Release, supra note 8, 59 FR at 59594-5. The Commission notes that demand securities are subject to paragraph (b)(5), as well as paragraph (c), of the Rule as a result of the amendments being adopted today.

<sup>334</sup> The Commission received no comments on this statement.

<sup>335</sup> See 1988 Proposing Release, supra note 58; the 1989 Adopting Release, supra note 8, 54 FR at 28811-12; and Securities Exchange Act Release No. 33741 (March 9, 1994), 59 FR 12748 (March 17, 1994) ("1994 Interpretive Release") (reaffirming the Commission's interpretation of the obligations of municipal underwriters under the antifraud provisions of the federal securities laws).

<sup>336</sup> See 1989 Adopting Release, supra note 8, 54 FR at 28811. See also 1988 Proposing Release, supra note 128, 53 FR at 37787.

with respect to underwriters' responsibilities under the antifraud provisions of the federal securities laws.<sup>337</sup>

The provisions of paragraph (b) of Rule 15c2-12 are intended to assist a municipal underwriter in meeting its "reasonable basis" obligations, including the requirement that an underwriter receive and review a nearly complete final official statement prior to bidding for or purchasing securities in connection with the offering.<sup>338</sup> Under paragraph (b)(5)(i)(C) of the Rule, the underwriter is obligated to reasonably determine that the issuer or obligated person has undertaken, in a written agreement or contract, for the benefit of the bondholders, to provide continuing disclosure documents to the MSRB.<sup>339</sup> Further, the Rule's definition of "final official statement" provides for the disclosure of any instances in the previous five years in which any person identified in the continuing disclosure agreement has failed to comply, in all material respects, with any previous informational undertakings in the continuing disclosure agreement.<sup>340</sup> When the Commission in 1994 adopted these provisions of the Rule, it stated its belief that the failure of the issuer or other obligated person to comply in all material respects with prior informational undertakings is information that is important to the market and, therefore, should

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<sup>337</sup> In light of the underwriter's obligation, as discussed in the 1988 Proposing Release, supra note 335, 53 FR at 37787-91, the 1989 Adopting Release, supra note 8, 54 FR 28811-12, and in the 1994 Interpretive Release, supra note 335, 59 FR 12757-58, to review the official statement and to have a reasonable basis for its belief in the accuracy and completeness of the official statement's key representations, the Commission noted that a disclaimer by an underwriter of responsibility for the information provided by the issuer or other parties without further clarification regarding the underwriter's belief as to accuracy, and the basis therefore, is misleading and should not be included in official statements. See 1994 Interpretive Release, supra note 335, 59 FR 12758 n.103.

<sup>338</sup> See 1988 Proposing Release, supra note 335, 53 FR at 37790.

<sup>339</sup> Pursuant to the 2008 Amendments, the MSRB is the sole information repository.

<sup>340</sup> Rule 15c2-12(f)(3), 17 CFR 15c2-12(f)(3).

be disclosed in the final official statement.<sup>341</sup> As the Commission noted at that time, the provision in the Rule regarding disclosure of a prior history of material non-compliance by issuers or other obligated persons with their undertakings was specifically intended to serve as an incentive to comply with their undertakings to provide secondary market disclosure.<sup>342</sup> Moreover, such disclosure would assist underwriters and others in assessing the reliability of issuers' or obligated persons' disclosure representations.<sup>343</sup> The Commission continues to believe in the importance of these Rule provisions and would like to remind underwriters of their obligations under Rule 15c2-12.

The Commission previously has stated that, in its view, the reasonableness of a belief in the accuracy and completeness of the key representations in the final official statement, and the extent of a review of the issuer's or other obligated person's situation necessary to arrive at that belief, will depend upon all the circumstances.<sup>344</sup> In both negotiated and competitively bid municipal offerings, the Commission expects, at a minimum, that underwriters will review the issuer's disclosure documents in a professional manner for possible inaccuracies and omissions. The Commission previously has provided a non-exclusive list of factors that it believes generally would be relevant in determining the reasonableness of an underwriter's basis for assessing the truthfulness of key representations in final official statements.<sup>345</sup> These factors include: (1) the extent to which the underwriter relied upon municipal officials, employees, experts, and other persons whose duties have given them knowledge of particular facts; (2) the role of the

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<sup>341</sup> See 1994 Amendments Adopting Release, supra note 8, 59 FR at 59594-5.

<sup>342</sup> Id. at 59595.

<sup>343</sup> Id.

<sup>344</sup> See 1988 Proposing Release, supra note 58, 53 FR at 37789, and 1989 Adopting Release, supra note 8, 54 FR 28811-12.

<sup>345</sup> Id.



underwriter (manager, syndicate member, or selected dealer); (3) the type of bonds being offered (general obligation, revenue, or private activity); (4) the past familiarity of the underwriter with the issuer; (5) the length of time to maturity of the bonds; and (6) whether the bonds are competitively bid or are distributed in a negotiated offering.<sup>346</sup> Sole reliance on the representations of the issuer will not suffice.<sup>347</sup>

The Commission has determined further to expound upon its prior interpretations regarding municipal underwriters' responsibilities. As articulated in a prior interpretation, the Commission believes that it is doubtful that an underwriter could form a reasonable basis for relying on the accuracy or completeness of an issuer's or obligated person's ongoing disclosure representations, if such issuer or obligated person has a history of persistent and material breaches or has not remedied such past failures by the time the offering commences.<sup>348</sup> The Commission believes that if the underwriter finds that the issuer or obligated person has on multiple occasions during the previous five years<sup>349</sup> failed to provide on a timely basis continuing disclosure documents, including event notices and failure to file notices, as required in a continuing disclosure agreement for a prior offering, it would be very difficult for the underwriter to make a reasonable determination that the issuer or obligated person would provide such information under a continuing disclosure agreement in connection with a subsequent offering. In the Commission's view, it also is doubtful that an underwriter could meet the reasonable belief standard without the underwriter affirmatively inquiring as to that filing

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<sup>346</sup> Id.

<sup>347</sup> See 1988 Proposing Release, supra note 58, 53 FR at 37789.

<sup>348</sup> See 1994 Amendments Adopting Release, supra note 8, 59 FR at 59595.

<sup>349</sup> 17 CFR 240.15c2-12(f)(3).

history.<sup>350</sup> The underwriter's reasonable belief should be based on its independent judgment, not solely on representations of the issuer or obligated person as to the materiality of any failure to comply with any prior undertaking. If the underwriter finds that the issuer or obligated person has failed to provide such information, the underwriter should take that failure into account in forming its reasonable belief in the accuracy and completeness of representations made by the issuer or obligated person.<sup>351</sup>

In the Proposing Release, the Commission solicited comment regarding alternative or additional ways in which an underwriter could satisfy its obligations, including obligations to ascertain if issuers or obligated persons are abiding by their municipal disclosure

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<sup>350</sup> The Commission notes that, in light of the adoption of the 2008 Amendments and their effective date of July 1, 2009, for disclosures made on or after July 1, 2009, an underwriter could verify that the information has been submitted electronically to the MSRB.

<sup>351</sup> In connection with event notices concerning the appointment of a successor or additional trustee or the name change of a trustee, if an issuer or obligated person obtains a contractual commitment from the trustee specifying that the trustee will provide notice of a change in the trustee's name to the MSRB or the issuer or obligated person, the trustee fails to provide such notice, and the issuer or obligated person otherwise is unaware of the trustee's name change, the Commission believes that the underwriter may take the trustee's failure to notify into account as a substantial mitigating factor in forming a reasonable belief as to the accuracy and completeness of the issuer's or obligated person's representation regarding compliance with its undertakings.

Moreover, for so long as an issuer or obligated person establishes and maintains policies and procedures reasonably designed in light of the relevant facts and circumstances to ensure compliance with its undertaking to provide notice of a rating change with respect to its municipal security to the MSRB in a timely manner, not in excess of ten business days after the occurrence of the rating change, and the issuer or obligated person regularly reviews the effectiveness of its policies and procedures and takes prompt action to remedy any deficiencies, the Commission believes that an underwriter, in forming a reasonable belief as to the accuracy and completeness of the issuer's or obligated person's representations regarding compliance with its undertakings, may take into account the issuer's or obligated person's policies and procedures, regular reviews, and prompt remedial action as a substantial mitigating factor in the event of the issuer's or obligated person's unintentional failure to provide such notice in the prescribed manner.

commitments.<sup>352</sup> The Commission specifically requested that commenters address the current practices used by underwriters to satisfy their “reasonable basis” obligation and any aspects of such practices that could be addressed through further Commission interpretation or rulemaking.

The Commission received comments expressing concern that it can be labor intensive and costly,<sup>353</sup> and even impossible,<sup>354</sup> for an underwriter to make a reasonable determination that an issuer or an obligated person would provide continuing disclosure information pursuant to the Commission’s interpretation. These commenters particularly pointed to the difficulties underwriters face in examining event disclosures for sufficiency.<sup>355</sup> The commenters also noted that, because underwriters are expected to examine disclosures over a five-year period preceding new offerings, they need to continue to depend on the Nationally Recognized Municipal Securities Information Repository (“NRMSIR”) network for such information, which entails searching for various filings in each of the NRMSIRs.<sup>356</sup> Consequently, the commenters suggested that underwriters be permitted to rely on representations by issuers or obligated persons that they are in compliance with previous disclosure commitments as a basis for forming a reasonable determination that such persons would comply going forward.<sup>357</sup>

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<sup>352</sup> See Proposing Release, supra note 2, 74 FR at 36848.

<sup>353</sup> See RBDA Letter at 2.

<sup>354</sup> See NABL Letter at 11-12 and SIFMA Letter at 4.

<sup>355</sup> See NABL Letter at 11-12, RBDA Letter at 2-3, and SIFMA Letter at 4.

<sup>356</sup> See RDBA Letter at 2 and SIFMA Letter at 4.

<sup>357</sup> See NABL Letter at 12, RBDA Letter at 3, and SIFMA Letter at 4. Further, one commenter asked the Commission to clarify that underwriters may take into account the significance, materiality, and extenuating circumstances of an issuer’s or obligated person’s non-compliance with event disclosure provisions of continuing disclosure agreements. See NAHEFA Letter at 4. As the Commission has stated above, an underwriter’s determination to recommend any municipal security must be on a “reasonable basis.” Therefore, the underwriter may consider such factors.

The Commission believes that the interpretation included in the Proposing Release is warranted, and it reiterates that interpretation in this Adopting Release. The Commission continues to believe that the benefits to investors from its interpretation justify the effort required of underwriters to determine whether an issuer has a history of repeatedly and materially breaching its undertakings.<sup>358</sup> The Commission has considered the comments described above and believes that it is appropriate to add to its interpretation to address the circumstances and extent of underwriter reliance on information provided by issuers and obligated persons concerning event disclosures, as raised by these comments.

The Commission acknowledges that it may not be possible in some cases for an underwriter independently to determine whether some events, for which an event notice is necessary, have occurred.<sup>359</sup> In order to obtain this information, an underwriter may take steps, such as asking questions of an issuer and, where appropriate, obtaining certifications from an issuer, obligated person or other appropriate party about facts, such as the occurrence of specific events listed in paragraph (b)(5)(i)(C) of the Rule (without regard to materiality), that the underwriter may need to know in order to form a reasonable belief in the accuracy and completeness of an issuer's or obligated person's ongoing disclosure representations. However, as discussed above, the underwriter may not rely solely upon the representations of an issuer or obligated person concerning the materiality of such events or that it has, in fact, provided annual filings or event notices to the parties identified in its continuing disclosure agreements (i.e.,

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<sup>358</sup> Since the Commission has not applied the primary market provisions of the Rule to demand securities, the definition of "final official statement" does not apply to demand securities. The Commission notes, however, that investors may have an expectation that official statements for demand securities will contain comparable information (such as a failure to comply, in all material respects, with any previous continuing disclosure undertakings) to that referred in the definition of "final official statement" under the Rule.

<sup>359</sup> Some of such information, such as the receipt of proposed or final determinations of taxability, may be known solely to the issuer or obligated person.

NRMSIRs, MSRB, and State Information Depositories).<sup>360</sup> Instead, an underwriter should obtain evidence reasonably sufficient to determine whether and when such annual filings and event notices were, in fact, provided.<sup>361</sup> The underwriter therefore must rely upon its own judgment, not solely on the representation of the issuer or obligated person, as to the materiality of any failure by the issuer or obligated person to comply with a prior undertaking.<sup>362</sup>

The Commission notes that the obligation of a Participating Underwriter to determine whether an issuer or an obligated person has filed continuing disclosure documents is not new but dates back to when paragraph (b)(5) of the Rule was adopted in 1994.<sup>363</sup> Moreover, the Commission notes that the launch of the MSRB's EMMA system should assist underwriters in complying with their obligations. To the extent underwriters must rely on NRMSIRs for disclosures made prior to the creation of EMMA,<sup>364</sup> the Commission notes that such reliance is time-limited. Since final official statements of offerings subject to the Rule must disclose the

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<sup>360</sup> Therefore, the underwriter may not likewise rely solely on a written certification from an issuer or obligated person that it has provided all filings or notices.

<sup>361</sup> For example, for annual filings and event notices due prior to July 1, 2009, an underwriter could reasonably rely upon information obtained from NRMSIRs and SIDs. In addition, an underwriter could rely upon other evidence that such information was provided, such as a certified copy of the annual filing or an event notice from a responsible issuer official, representative of an obligated person, or a designated agent and a receipt from a delivery service or other evidence that the information had, in fact, been sent. For filings made on or after July 1, 2009, however, an underwriter should examine the filings available on the MSRB's EMMA system. If the underwriter finds that some annual filings or event notices appear to be missing, it may request the issuer official or representative of an obligated person to provide a written certification and evidence showing whether and when such information was provided to the MSRB.

<sup>362</sup> The Commission notes that the definition of "final official statement" in the Rule provides for the inclusion of any instances in the previous five years in which each person specified pursuant to Rule 15c2-12 (b)(5)(ii) failed to comply, in all material respects, with any previous undertakings in a written contract or agreement specified in Rule 15c2-12 (b)(5)(i).

<sup>363</sup> See 1994 Amendments Adopting Release, *supra* note 8.

<sup>364</sup> See 2008 Amendments Adopting Release, *supra* note 8.

failures of an issuer or obligated person to comply with continuing disclosure undertakings only for the previous five years, underwriters presumably will no longer need to rely on various NRMSIRs within approximately four years.<sup>365</sup>

V. **Paperwork Reduction Act**

The Rule, as amended, contains “collection of information requirements” within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>366</sup> In accordance with 44 U.S.C. 3507 and 5 CFR 1320.11, the Commission submitted revisions to the currently approved collection of information titled “Municipal Securities Disclosure” (17 CFR 240.15c2-12) (OMB Control No. 3235-0372) to OMB. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

In the Proposing Release, the Commission solicited comments on the collection of information requirements. The Commission noted that the estimates of the effect that the amendments will have on the collection of information were based on data from various sources, including the most recent PRA submission for Rule 15c2-12. As discussed above, the Commission received twenty-nine comment letters on the proposed rulemaking. Of the comment letters the Commission received, some commenters addressed the collection of information aspects of the proposal.<sup>367</sup> The Commission recently received data from the MSRB reflecting the number of submissions to its EMMA system’s continuing disclosure service for the

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<sup>365</sup> Since EMMA became effective as of July 1, 2009, continuing disclosure documents for approximately the past year can be found centrally within that system. Id.

<sup>366</sup> 44 U.S.C. 3501 et seq.

<sup>367</sup> See NABL Letter, e-certus Letter I, SIFMA Letter, GFOA Letter, Connecticut Letter, California Letter, San Diego Letter, NAHEFFA Letter, CHEFA Letter, Kutak Letter, Halgren Letter, Los Angeles Letter, ICI Letter, Fidelity Letter, Metro Water Letter, NFMA Letter, CRRC Letter, and WCRR Letter.

eight-month period from July 1, 2009, through February 28, 2010.<sup>368</sup> This data includes the number of annual filings, event notices, and failure to file notices that were submitted to EMMA during this period. Because the EMMA system is now in operation and issuers or their agents are submitting continuing disclosure documents to it, the MSRB is able to provide the Commission with numbers for continuing disclosure documents for an eight-month period, based on its actual experience with the new system. When the eight months of EMMA data is annualized, the resulting estimate corresponds closely with the Commission's collection of information for estimates of continuing disclosure submissions in the Proposing Release.<sup>369</sup> The Commission is revising its estimates contained in the Proposing Release slightly, however, to provide estimates based on eight months of actual data provided by the MSRB for annual filings, event notices, and failure to file notices.<sup>370</sup>

A. Summary of Collection of Information

Pursuant to paragraph (b) of Rule 15c2-12, a Participating Underwriter is required: (1) to obtain and review an official statement "deemed final" by an issuer of the securities, except for the omission of specified information, prior to making a bid, purchase, offer, or sale of municipal securities; (2) in non-competitively bid offerings, to send, upon request, a copy of the most recent preliminary official statement (if one exists) to potential customers; (3) to send, upon request, a copy of the final official statement to potential customers for a specified period of time; (4) to contract with the issuer to receive, within a specified time, sufficient copies of the

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<sup>368</sup> See e-mail from Ernesto A. Lanza, General Counsel, MSRB, to Martha M. Haines, Assistant Director and Chief, Office of Municipal Securities, Division, Commission, dated March 3, 2010 (providing statistics relating to the number of submissions to the MSRB's EMMA continuing disclosure service). The MSRB commenced operating the continuing disclosure service of the EMMA system on July 1, 2009.

<sup>369</sup> See infra notes 417, 418, and 421.

<sup>370</sup> See id. See also infra Section V.D.

final official statement to comply with the Rule's delivery requirement, and the requirements of the rules of the MSRB; and (5) before purchasing or selling municipal securities in connection with an offering, to reasonably determine that the issuer or obligated person has undertaken, in a written agreement or contract for the benefit of holders of such municipal securities, to provide annual filings, event notices, and failure to file notices (i.e., continuing disclosure documents) to the MSRB in an electronic format as prescribed by the MSRB. Under paragraph (c) of the Rule, a broker-dealer that recommends the purchase or sale of a municipal security is required to have procedures in place that provide reasonable assurance that it will receive prompt notice of any event specified in paragraph (b)(5)(i)(C) of the Rule and any failure to file annual financial information regarding the security.

Under the amendments, the Commission is modifying paragraph (d)(1)(iii) of the Rule by adopting changes to paragraph (d)(5) to the Rule, thereby applying paragraphs (b)(5) and (c) of the Rule to a primary offering of demand securities in authorized denominations of \$100,000 or more (i.e., demand securities). This change applies to any initial offering and remarketing that is a primary offering of demand securities occurring on or after the compliance date of the amendments. However, to address commenters' concerns about the impact of the proposal on existing demand securities, the amendment does not apply to remarketings of demand securities that are outstanding in the form of demand securities on the day preceding the amendments' compliance date and that continuously have remained outstanding in the form of demand securities (i.e., such securities can qualify for a limited grandfather provision).<sup>371</sup>

Under paragraph (b)(5)(i)(C) of Rule 15c2-12, a Participating Underwriter is required to reasonably determine that the issuer or obligated person has undertaken in a continuing

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<sup>371</sup> See supra Section III.A.



disclosure agreement to provide an event notice to the MSRB upon any of the following events: (1) principal and interest payment delinquencies with respect to the securities being offered; (2) unscheduled draws on debt service reserves reflecting financial difficulties; (3) unscheduled draws on credit enhancements reflecting financial difficulties; (4) substitution of credit or liquidity providers, or their failure to perform; (5) defeasances; and (6) rating changes.<sup>372</sup> Under the amendments, the Commission is deleting the “if material” condition that existed in the Rule with respect to these events.

The Commission, however, is retaining the “if material” condition regarding certain other events listed in paragraph (b)(5)(i)(C) of the Rule. A Participating Underwriter will continue to be required to reasonably determine that the issuer or obligated person has undertaken in a continuing disclosure agreement to provide notice to the MSRB with respect to the following events, if material: (1) non-payment related defaults; (2) modifications to rights of security holders; (3) bond calls; and (4) release, substitution, or sale of property securing repayment of the securities.

In addition, under the amendments, the Commission is adding the following event items to paragraph (b)(5)(i)(C) of the Rule: (1) the issuance by the IRS of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the securities, or other material events affecting the tax status of the security; (2) tender offers; (3) bankruptcy, insolvency, receivership or similar event of the obligated person; (4) the consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive

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<sup>372</sup> 17 CFR 240.15c2-12(b)(5)(i)(C).

agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material; and (5) appointment of a successor or additional trustee, or the change of name of a trustee, if material.

Further, under the amendments, Participating Underwriters will be required to reasonably determine that the issuer or obligated person has undertaken in a continuing disclosure agreement to provide event notices to the MSRB, in an electronic format as prescribed by the MSRB, in a timely manner not in excess of ten business days, rather than simply in “a timely manner.”

B. Use of Information

By specifying the time period for submission of event notices, expanding the Rule’s current categories of events, and modifying an exemption in the Rule for demand securities, the amendments are intended to promptly make available to broker-dealers, institutional and retail investors, and others important information about significant events relating to municipal securities and their issuers or obligated persons. The amendments should assist investors and other municipal securities market participants to obtain information about municipal securities, including demand securities, and thus facilitate their investment decisions and reduce the likelihood of fraud facilitated by inadequate disclosure. In addition, the amendments should provide brokers, dealers, and municipal securities dealers with access to important information about municipal securities that they can use to carry out their obligations under the securities laws. This information may be used by individual and institutional investors, underwriters of municipal securities, other market participants, including broker-dealers and municipal securities dealers, analysts, municipal securities issuers, the MSRB, vendors of information regarding municipal securities, the Commission and its staff, and the public generally.

C. Respondents

The paperwork collection associated with the Commission's amendments to Rule 15c2-12 applies to broker-dealers, issuers of municipal securities, and the MSRB. Although in the Proposing Release the Commission estimated that its proposed amendments would not change the number of broker-dealer respondents, the Commission estimated that there would be an increase in the number of issuer respondents. Because the proposed amendments would have expanded the types of securities covered under subparagraphs (b)(5) and (c) of the Rule, there would have been an increase in the number of issuers having a paperwork burden. As discussed below, the Commission estimated that the proposed revision of the Rule's exemption for demand securities would increase the number of issuers with a paperwork burden by 2,000 issuers, for a total of 12,000 issuer respondents.<sup>373</sup> In the Proposing Release, the Commission estimated that the number of respondents impacted by the paperwork collection associated with the Rule would consist of 250 broker-dealers,<sup>374</sup> 12,000 issuers,<sup>375</sup> and the MSRB.<sup>376</sup> The Commission included

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<sup>373</sup> See Proposing Release, *supra* note 2, 74 FR at 36849-50. See also *infra* note 402 and accompanying text.

<sup>374</sup> As discussed in the Proposing Release and below, the Commission estimates that 250 broker-dealers will serve as Participating Underwriters in offerings of municipal securities and will have a paperwork collection burden as a result of the amendments. This estimate is based on the Commission's 2008 PRA submission (defined below) that included the estimated number of broker-dealers that would serve as Participating Underwriters in offerings of municipal securities in any given year and would therefore be subject to a collection of information burden under Rule 15c2-12. Although this estimate of 250 broker-dealers was included in the 2008 PRA submission, the estimated number of broker-dealers that could serve as Participating Underwriters in offerings of municipal securities is not expected to change from the 2008 PRA submission or as a result of the amendments. See Proposing Release, *supra* note 2, 74 FR at 36849-50. See also PRA-2008-revised 15c2-12 Justification, Municipal Securities Disclosure (OMB Control No. 3235-0372), OMB, available at [http://www.reginfo.gov/public/do/PRAViewDocument?ref\\_nbr=200812-3235-013](http://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=200812-3235-013) ("2008 PRA submission").

<sup>375</sup> As discussed in the Proposing Release and below, the Commission estimates that 12,000 issuers will have a paperwork collection burden as a result of the amendments. This

these estimates of the number of respondents in the Proposing Release and received no comments on them. The Commission continues to believe that they are appropriate.

As discussed above, the Commission is revising its amendment to the Rule's exemption for demand securities to include a limited grandfather provision for remarketings of currently outstanding demand securities.<sup>377</sup> The Commission believes that fewer issuers initially will be affected by the amendments than estimated in the Proposing Release as a result of the limited grandfather provision, which could result in a somewhat lower number of issuer respondents that are subject to the collection of information under the Rule than estimated in the Proposing Release. However, the Commission notes that the effects of the limited grandfather provision will diminish over time as demand securities mature or are redeemed and new demand securities that are subject to the Rule amendments are issued. In addition, the Commission has no reason to believe the overall number of issuers of demand securities will change materially going forward as a result of these amendments. Because of the effects of the limited grandfather provision will diminish over time, the Commission continues to believe that 12,000 issuer respondents is an appropriate estimate.

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estimate is based on the Commission's 2008 PRA submission that included the estimate of 10,000 issuers that would have a paperwork burden under Rule 15c2-12 in any given year and is not expected to change from the 2008 PRA submission. See 2008 PRA submission, supra note 374. In the Proposing Release, this estimate of 10,000 issuers was estimated to increase by 20%, to 12,000 issuers, as described below, to account for the proposed amendment to the Rule relating to demand securities. As described below, the final amendments will not change the estimated number of issuers that will submit annual financial information, material event notices, and failure to file notices to the MSRB. See Proposing Release, supra note 2, 74 FR at 36850, n. 151 and accompanying text, for a discussion of how the Commission arrived at its estimate of a 20% increase in the number of issuers as a result of the proposed amendment relating to demand securities. See also infra note 402.

<sup>376</sup> See Proposing Release, supra note 2, 74 FR at 36849-50. See also 2008 PRA submission, supra note 374.

<sup>377</sup> See infra Section III.A.

D. Total Annual Reporting and Recordkeeping Burden

The Commission estimates the aggregate information collection burden for the amended Rule to consist of the following:

1. Broker-Dealers

As discussed in the Proposing Release, the Commission estimated that approximately 250 broker-dealers potentially could serve as Participating Underwriters in an offering of municipal securities.<sup>378</sup> The Commission received no comments on this estimate. The Commission has reviewed this estimate and continues to believe that, under the amendments, the maximum number of broker-dealers subject to a paperwork burden will be 250.

a. Amendment to Modify the Exemption for Demand Securities

As discussed in the Proposing Release, the Commission estimated that the total annual burden on all 250 broker-dealers under the Rule is 250 hours (1 hour annually per broker-dealer).<sup>379</sup> In the Proposing Release, the Commission estimated that the amendment to modify the exemption from the Rule for a primary offering of demand securities would increase the number of issuers with municipal securities offerings that are subject to the Rule annually by 20%.<sup>380</sup> This percentage was based on the Commission's estimate of the ratio of demand securities outstanding to the municipal securities market generally.<sup>381</sup>

As noted above, the Commission is adopting a limited grandfather provision with respect to currently outstanding demand securities. Although the Commission believes that the limited

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<sup>378</sup> See Proposing Release, supra note 2, 74 FR at 36850.

<sup>379</sup> Id.

<sup>380</sup> See also infra note 402 and accompanying text for a description of how the Commission arrived at its estimate of a 20% increase in the number of issuers as a result of the amendment relating to demand securities.

<sup>381</sup> Id.

grandfather provision initially could result in a somewhat lower number of issuer respondents, for the reasons noted above, it continues to believe that a 20% increase in the number of issuers with offerings subject to the Rule is appropriate.<sup>382</sup>

As discussed in the Proposing Release, the Commission estimated that this 20% increase in the number of issuers with offerings subject to the Rule also would increase the estimated average annual burden for each broker-dealer by 20%, or .20 hours,<sup>383</sup> and the total estimated annual paperwork burden for all broker-dealers by 20%, or 50 hours.<sup>384</sup> This increased burden represents the additional time broker-dealers would need annually to review the continuing disclosure agreements associated with the offerings of demand securities subject to the amended Rule. As discussed in the Proposing Release and below,<sup>385</sup> the Commission notes that the continuing disclosure agreements that are reviewed by broker-dealers as part of their obligation under the Rule tend to be form agreements. The amendments to the Rule that the Commission is adopting will result in minor changes to certain provisions of these agreements. However, because these continuing disclosure agreements tend to be standard form agreements, the Commission does not believe that there will be a substantial increase in the annual hourly burden for broker-dealers under the amendments.

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<sup>382</sup> As discussed in Section V.D.2., infra, the Commission in the Proposing Release solicited comment on the estimated 20% increase in the number of issuers affected by a paperwork burden and received no comments on this estimate. As discussed below, the Commission continues to believe that this estimate is appropriate.

<sup>383</sup> 20% or .20 hours (12 minutes = 60 minutes x .20 (20%)). See Proposing Release, supra note 2, 74 FR at 36850.

<sup>384</sup> 250 hours (total annual burden for all broker-dealers under the Rule prior to the amendments) x .20 (20% increase in total hourly burden) = 50 hours. This estimated increase in the annual burden for broker-dealers also accounts for their review of continuing disclosure agreements in connection with those remarketings of demand securities that are now subject to the Rule. See Proposing Release, supra note 2, 74 FR at 36850.

<sup>385</sup> See infra Section V.E.2.a. See also Proposing Release, supra note 2, 74 FR at 36850.

In the Proposing Release, the Commission solicited comments on broker-dealers' collection of information burdens, including those relating to the amendment to modify the exemption for demand securities. One commenter believed that the proposal failed to assess the "substantial additional time and expense" required by Participating Underwriters and remarketing agents to review and verify disclosure about obligated persons in offerings of demand securities, unless the amendments to the Rule were clarified to exclude offerings of LOC-backed demand securities without primary or continuing disclosure about the underlying obligor.<sup>386</sup> This comment appears to relate to a Participating Underwriter's review of issuers' primary offering disclosure. As discussed in Section III above, the amendments are not eliminating the exemption for demand securities from paragraphs (b)(1) – (4) of the Rule, which relate to primary offering disclosure. As a result, Participating Underwriters in offerings of demand securities will continue to be exempt from the primary offering provisions of the Rule. For this reason, the Commission does not believe that a Participating Underwriter will incur "substantial additional time and expense" in connection with the amendments, as suggested by the commenter. The Commission has considered this comment, reviewed its estimate in the Proposing Release in light of the comment, and believes that it is unnecessary to revise the total hourly burden for broker-dealers from its estimate in the Proposing Release.

Therefore, the Commission continues to believe that its estimate that 250 broker-dealers will incur an estimated average burden of 300 hours per year to comply with the Rule, as amended, is appropriate.<sup>387</sup>

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<sup>386</sup> See NABL Letter at 12-13.

<sup>387</sup> 250 hours (total estimated annual hourly burden for all broker-dealers under the Rule prior to the amendments) + 50 hours (total estimated additional annual hourly burden for all broker-dealers under the amendments) = 300 hours.

b. Amendments to Events to be Disclosed Under a Continuing Disclosure Agreement

As described above, the amendments to paragraph (b)(5)(i)(C) of the Rule add four new disclosure events to the Rule, as well as amend an existing disclosure event, and modify the number of events that are subject to a materiality determination. In addition, the amendments to paragraphs (b)(5)(i)(C) and (d)(2)(ii)(B) of the Rule change the timing for filing event notices from “in a timely manner” to “in a timely manner not to exceed ten business days.” The amendments do not change a broker-dealer’s obligation under the Rule to reasonably determine that the issuer or obligated person has undertaken, in a written agreement or contract, for the benefit of holders of such municipal securities, to provide annual filings, event notices, and failure to file notices to the MSRB.<sup>388</sup> Accordingly, because the broker-dealer already is under an obligation to reasonably determine that an appropriate undertaking has been made, the Commission does not believe that the amendments relating to the timing and scope of event notices will affect the annual paperwork burden for broker-dealers. In the Proposing Release, the Commission solicited comments on broker-dealers’ collection of information requirements, including this estimate relating to the amendments to events to be disclosed under a continuing disclosure agreement. The Commission received no comments on this estimate and continues to believe that it is appropriate.

c. One-Time Paperwork Burden

The Commission estimates that a broker-dealer will incur a one-time paperwork burden to have its internal compliance attorney prepare and issue a notice advising its employees about

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<sup>388</sup> The Commission notes that, while the amendments do not change this obligation, broker-dealers will need to reasonably determine that the written agreement or contract entered into by an issuer or obligated person contains the change to the timing for filing event notices (*i.e.*, not in excess of ten business days of the occurrence of the event), as well as the new and revised disclosure events.



the final revisions to Rule 15c2-12. In the Proposing Release, the Commission estimated that it would take a broker-dealer's internal compliance attorney approximately 30 minutes to prepare and issue such a notice.<sup>389</sup> The Commission believes that the task of preparing and issuing a notice advising the broker-dealer's employees about the amendments is consistent with the type of compliance work that a broker-dealer typically handles internally. In the Proposing Release, the Commission solicited comments on broker-dealers' collection of information requirements, including this estimate relating to broker-dealers' one-time paperwork burden. The Commission received no comments on this estimate. Consistent with its estimate in the Proposing Release, the Commission estimates that 250 broker-dealers will each incur a one-time, first-year burden of 30 minutes to prepare and issue this notice.

d. Total Annual Burden for Broker-Dealers

Under the amendments, the total burden on broker-dealers is estimated to be 425 hours for the first year<sup>390</sup> and 300 hours for each subsequent year.<sup>391</sup> The Commission included these estimates in the Proposing Release and solicited comments on them. In addition to the comment discussed above relating to broker-dealers' obligations with respect to demand securities, one commenter stated generally that its "review of [the Proposing Release] does not suggest any unnecessary burden on municipal underwriters."<sup>392</sup> This commenter observed that, "[b]y contrast, [the Proposing Release] suggests that past practices have been too lax, and the

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<sup>389</sup> See Proposing Release, supra note 2, 74 FR at 36850-51.

<sup>390</sup>  $(250 \text{ (broker-dealers impacted by the amendments)} \times 1.20 \text{ hours}) + (250 \text{ (broker-dealers impacted by the amendments)} \times .5 \text{ hour (estimate for one-time burden to issue notice regarding broker-dealer's obligations under the amendments)}) = 425 \text{ hours.}$

<sup>391</sup>  $250 \text{ (broker-dealers impacted by the amendments)} \times 1.20 \text{ hours} = 300 \text{ hours.}$

<sup>392</sup> See e-certus Letter I at 9.

Commission is simply making underwriters' due diligence burden reasonable.<sup>393</sup> This commenter supported the proposal and suggested additional changes to strengthen Participating Underwriters' obligations under the Rule.<sup>394</sup> The Commission has considered all of the comments relating to the paperwork collection burden applicable to broker-dealers and, for the reasons discussed above, continues to believe that its estimates are appropriate.<sup>395</sup>

## 2. Issuers

Issuers' undertakings regarding the submission of annual filings, event notices, and failure to file notices that are set forth in continuing disclosure agreements impose a paperwork burden on issuers of municipal securities.<sup>396</sup> In the Proposing Release, the Commission provided estimates regarding the number of annual filings, event notices, and failure to file notices that issuers would submit under the proposed amendments. These estimates were based on the best estimates of the MSRB staff at that time, which were made prior to the MSRB's experience with its new EMMA system. The Commission recently received data from the MSRB reflecting the number of submissions to the EMMA system's continuing disclosure service for the eight-month period from July 1, 2009, through February 28, 2010 ("Sample Period").<sup>397</sup> This data includes the number of annual filings, event notices, and failure to file notices that were submitted during

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<sup>393</sup> Id.

<sup>394</sup> See e-certus Letter I at 9-11.

<sup>395</sup> In the Proposing Release, the Commission provided interpretive guidance with respect to the obligations of Participating Underwriters under the federal securities laws. In connection with this interpretation, the Commission solicited comment regarding alternative or additional ways in which an underwriter could satisfy its obligations, including obligations to ascertain if issuers or obligated persons are abiding by their municipal disclosure commitments. See Proposing Release, supra note 2, 74 FR at 36848. The Commission received comments in response to this solicitation, which are discussed in Section IV. of this release.

<sup>396</sup> For purposes of this section, the term "issuers" refers to issuers and obligated persons.

<sup>397</sup> See supra note 368.

this Sample Period. To provide PRA estimates that are based on the MSRB's actual experience with respect to submissions of annual filings, event notices, and failure to file notices to its EMMA system, the Commission has elected to use the data obtained for the Sample Period to revise its estimates in the Proposing Release.<sup>398</sup> Because the Sample Period is less than a full year,<sup>399</sup> the Commission has annualized these numbers for the purpose of revising its PRA estimates below.<sup>400</sup>

a. Amendment to Modify the Exemption for Demand Securities

The Commission believes that the amendment to delete paragraph (d)(1)(iii) from the Rule, which contains an exemption from the Rule for a primary offering of demand securities, and add new paragraph (d)(5) to the Rule to apply paragraphs (b)(5) and (c) of the Rule to demand securities, will increase the number of issuers with a paperwork burden under the Rule.

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<sup>398</sup> The Commission's estimates in the Proposing Release are somewhat lower than those derived from the Sample Period for annual filings and event notices and somewhat higher for failure to file notices, see infra notes 417, 418, and 421.

<sup>399</sup> The Commission notes that, although the MSRB is able to provide actual numbers of continuing disclosure documents that it has received for the Sample Period, it is unable to provide any actual or estimated number of issuers that have submitted continuing disclosure documents to the EMMA system. This is because issuers submit their filings using the CUSIP number for the security. Because issuers could have several issuances of outstanding bonds, they could submit documents under more than one CUSIP number. Because of the potential for over-counting the number of issuers with a paperwork burden if the Commission were to rely on CUSIP numbers as a proxy for the number of affected issuers, it has elected to base its estimates for the number of issuers with a paperwork burden on estimates included in the Proposing Release.

<sup>400</sup> The Commission notes that annualizing the data provided by the MSRB for the Sample Period could have some limitations, particularly since the Sample Period covered the period of implementation of the EMMA system. Notwithstanding these limitations, the Commission has reviewed the eight months of data provided by the MSRB during the Sample Period and did not identify any particular trends in the data that would suggest that annualizing these numbers would result in an underestimate of number of filings that the MSRB would receive during a twelve-month period. Therefore, the Commission believes that annualizing this data provides a reasonable basis for revising its PRA estimates.

In the Proposing Release, the Commission estimated that the Rule affected approximately 10,000 issuers.<sup>401</sup> Using the estimate of 10,000 issuers, the Commission estimated in the Proposing Release, and estimates again now, that the number of issuers with paperwork burden as a result of the amendments will increase by approximately 20%<sup>402</sup> to 12,000 issuers.<sup>403</sup> These additional issuers will increase the aggregate number of annual filings, event notices, and failure to file notices submitted each year. As noted above, the Commission is revising its amendment to the exemption for demand securities in the Rule to include a limited grandfather provision for remarketings of currently outstanding demand securities.<sup>404</sup> Also as noted above, the Commission believes that initially the limited grandfather provision could result in a somewhat lower number of issuer respondents that are subject to the collection of information under the

<sup>401</sup> See Proposing Release, *supra* note 2, 74 FR at 36851. See also *supra* note 375 for an explanation of the estimate of 10,000 issuers.

<sup>402</sup> *Id.* As described in the Proposing Release, in 2008, there were approximately 2,000 offerings of demand securities. See also Two Decades of Bond Finance: 1989-2008, The Bond Buyer/Thomson Reuters 2009 Yearbook 7 (Matthew Kreps ed., SourceMedia, Inc.) (2009). To provide conservative estimates, the Commission elected to assume that all 2,000 offerings of demand securities were issued by separate issuers and that each of those issuers currently is not a party to a continuing disclosure agreement that provides for the submission of continuing disclosure documents to the MSRB. Thus, the Commission estimated that approximately 2,000 additional issuers would be affected by the proposed amendments to the Rule. These 2,000 additional issuers represent a 20% increase in the total number of issuers that would have a burden under Rule 15c2-12 (10,000 (number of issuers affected by the Rule prior to the amendments)/2,000 (number of additional issuers under the amendments to the Rule) x 100 = 20%). The Commission notes that the above-referenced publication has not been updated and, accordingly believes that this estimate, which is predicated on 2,000 offerings of demand securities, continues to be based on the most recent information available.

<sup>403</sup> 10,000 (number of issuers affected by the Rule prior to the amendments) x 1.20 (20% increase) = 12,000. The Commission acknowledges that greater precision in determining the number of issuers that will have a burden under the amendment is not possible. For purposes of this analysis, the Commission assumes that all issuers of demand securities currently are not a party to a continuing disclosure agreement that provides for the submission of continuing disclosure documents to the MSRB. The Commission realizes that this assumption may result in an overestimate of the number of issuers with a burden.

<sup>404</sup> See *supra* Section III.A.

Rule than was estimated in the Proposing Release. However, the Commission notes that the effects of the limited grandfather provision will diminish over time as demand securities mature or are redeemed. In addition, the Commission has no reason to believe that the overall number of issuers of demand securities will change materially going forward as a result of these amendments. Because of this factor, the Commission continues to believe that 12,000 issuer respondents is an appropriate estimate.

In the Proposing Release, the Commission stated that the revision to the Rule's exemption for demand securities would not alter the Commission's previous PRA estimates of the hourly burdens for an issuer to prepare and submit an annual filing (45 minutes), an event notice (45 minutes), and a failure to file notice (30 minutes).<sup>405</sup> Thus, the Commission estimated that the aggregate number of annual filings, event notices, and failure to file notices submitted by issuers also would increase by 20% from the previous estimates.<sup>406</sup> In the Proposing Release, the Commission solicited comments on issuers' collection of information requirements. The Commission received comments relating to the hourly burdens associated with this amendment. These comments are addressed in Section V.D.2.a.i, below.

i. Comments Relating to Paperwork Burdens in Connection with the Amendment Relating to Demand Securities

Several commenters offered their views on the impact of the proposal to modify the exemption for demand securities.<sup>407</sup> Of these commenters, one expressed concern that the

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<sup>405</sup> See Proposing Release, supra note 2, 74 FR at 36851.

<sup>406</sup> The Commission believes that this estimated 20% increase in the number of each type of continuing disclosure document filed is appropriate since it maintains a corresponding relationship between the number of issuers and the number of each type of document submitted by these issuers, as discussed in the Proposing Release. See Proposing Release, supra note 2, 74 FR at 36850, n.151.

<sup>407</sup> See, e.g., SIFMA Letter, NABL Letter, GFOA Letter (expressed support for the statements made in the NABL Letter), CRRC Letter, and WCRRRC Letter (WCRRRC

revision of the exemption for demand securities could have an “insurmountable administrative burden” on smaller issuers and non-profit obligated persons that issued securities before the compliance date of the proposed amendments.<sup>408</sup> This commenter believed that the proposal could be difficult for these entities to comply with, if they were required to enter into continuing disclosure agreements years after the original issuance of the bonds.<sup>409</sup> Although this commenter did not specifically define what it meant by “administrative burden,” this commenter may be concerned about the paperwork collection hourly burden on smaller issuers and obligated persons resulting from this amendment.

As proposed by the Commission, the amendment would have applied to any initial offering and remarketing that is a primary offering of demand securities occurring on or after the compliance date of the amendments. However, to address commenters’ concerns about the impact of the proposal on outstanding demand securities, the Commission is adopting a limited grandfather provision that provides that the amendments will not apply to a remarketing of demand securities that were issued prior to the amendments’ compliance date and that continuously have remained outstanding as demand securities. While the Commission continues to acknowledge that the amendment will place some additional burden on issuers of demand securities issued on or after the compliance date of the amendments,<sup>410</sup> the amendment as adopted is forward-looking and generally will not apply to securities issued before the

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endorsed all of the positions expressed in the CRRRC Letter) (the concerns expressed by CRRRC and WCRRRC are discussed in infra Sections V.D.2.b and V.E.2.c).

<sup>408</sup> See SIFMA Letter.

<sup>409</sup> Id.

<sup>410</sup> Issuers of demand securities with fixed-rate debt outstanding already would be subject to a continuing disclosure agreement in which they undertake to provide continuing disclosure documents, so they would be subject to minimal – if any – increased burdens. See supra Section V.D.2.a.

compliance date of the proposed amendments. Therefore, the Commission does not believe that the amendments will create an “insurmountable administrative burden” for issuers, including smaller issuers and obligated persons, as expressed by the above commenter. The Commission believes that the limited grandfather provision should largely alleviate the concerns expressed by this commenter with respect to demand securities that are currently outstanding.

As the Commission stated in the Proposing Release, and reiterates here, it does not anticipate a significant increase in disclosure burdens with respect to demand securities.<sup>411</sup> The Commission acknowledges that, if issuers or obligated persons with respect to demand securities have not previously issued securities subject to continuing disclosure agreements, they will be entering into such agreements for the first time and thereby will incur some time and expense to provide continuing disclosure documents to the MSRB.<sup>412</sup> The Commission believes that its estimate of a 20% increase in the number of issuers or obligated persons that may be affected by the Rule appropriately reflects the increase in the number of issuers that will have a paperwork burden. The commenter did not dispute this estimate. In addition, as the Commission noted in proposing these amendments, many issuers and obligated persons with respect to demand securities are likely to have outstanding fixed rate securities and already have entered into continuing disclosure agreements consistent with the Rule.<sup>413</sup> Because any existing continuing disclosure agreement would obligate an issuer or an obligated person to provide annual filings, event notices, or failure to file notices with respect to these fixed rate securities, providing disclosures with respect to these demand securities is not expected to be a significant additional burden.

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<sup>411</sup> See supra notes 402 to 406 and accompanying text.

<sup>412</sup> Id.

<sup>413</sup> See Proposing Release, supra note 2, 74 FR at 36837.

Another commenter stated that the Proposing Release “largely failed to assess the substantial additional time and expense required by issuers and other obligated persons to prepare (and for underwriters and remarketing agents to professionally review and check) disclosure about obligated persons in offerings of demand securities, unless the proposed amendments are clarified so as not to preclude offerings of LOC-backed demand securities without primary or continuing disclosure about the underlying obligor.”<sup>414</sup> As discussed above, the amendments are not eliminating the exemption for demand securities from paragraphs (b)(1) – (4) of the Rule, which relate to primary offering disclosure. As a result, under the amendments, issuers of demand securities will not have a paperwork burden with respect to primary offering disclosures. Accordingly, the commenter’s concern appears misplaced.

ii. Annual Filings

Under the amendment to modify the Rule’s exemption for demand securities, the Commission estimates that 12,000 municipal issuers with continuing disclosure agreements will prepare and submit approximately 22,909 annual filings yearly.<sup>415</sup>

As discussed in the Proposing Release, the Commission estimated, and continues to believe, that an issuer will require approximately 45 minutes to prepare and submit annual filings

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<sup>414</sup> See NABL Letter (the GFOA Letter expressed support for the statements made in the NABL Letter). The Commission notes that this commenter disputed that the Commission’s 45 minute estimate in connection with the amendment to the time frame for the submission of event notices. This comment is addressed in infra Section V.D.2.b.i.

<sup>415</sup>  $19,091 (12,791(\text{total annual filings submitted to the MSRB during the Sample Period})/.67) (\text{annualized number of annual filings submitted to the MSRB based on the Sample Period}) \times 1.20 (20\% \text{ increase in filings under the amendments}) = 22,909 \text{ annual filings (estimated number of annual filings under the amendments). In the Proposing Release, the Commission estimated 18,000 annual filings would be submitted to the MSRB under the amendments. The Commission is revising this estimate to 22,909 filings to reflect actual filings submitted to the MSRB. This revised estimate is higher than the Commission’s estimate in the Proposing Release by 4,909 annual filings or by approximately 27.27\%.$



to the MSRB in an electronic format.<sup>416</sup> Therefore, under the amendments, the total burden on issuers of municipal securities to prepare and submit 22,909 annual filings to the MSRB in an electronic format is estimated to be 17,182 hours.<sup>417</sup> Other than as noted above, the Commission received no other comments on its estimates to prepare and submit annual filings under the amendment for demand securities. The Commission has considered the comments received and believes that its estimates, as revised to take into account the data provided by the MSRB, are appropriate.

iii. Event Notices

Under the amendment to modify the Rule's exemption for demand securities, the Commission estimates that the 12,000 municipal issuers with continuing disclosure agreements will prepare and submit approximately 74,605 event notices yearly.<sup>418</sup> As the Commission

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<sup>416</sup> The Commission received comments relating to the time it would take an issuer to prepare and submit an event notice under the amendments. These comments are addressed in infra Section V.D.2.b.

<sup>417</sup>  $22,909$  (estimated number of annual filings under the amendments)  $\times$   $.75$  hours (45 minutes) (estimated time to prepare and submit annual filings under the amendments) =  $17,181.75$  (rounded to 17,182 hours). In the Proposing Release, the Commission estimated number of hours to prepare and submit annual filings under the amendment would be 13,500 hours. The Commission is revising this estimate to 17,182 hours. This revised estimate is higher than the estimate in the Proposing Release by 3,682 hours or by approximately 27.27%.

<sup>418</sup>  $62,171$  ( $41,654$  (total number of event notice filings submitted to the MSRB during the Sample Period)/ $.67$ ) (annualized number of event notices submitted to MSRB based on the sample period)  $\times$   $.120$  (20% increase in filings under the amendments) =  $74,605$  event notices (estimated number of event notices under the amendments)). In the Proposing Release, the Commission estimated 72,000 event notice filings would be submitted to the MSRB under the amendments. The Commission is revising its estimate to 74,605 event notice filings. This estimate is higher than the estimate in the Proposing Release by 2,605 event notices or approximately 3.62%. In its analysis of the data the Commission received from the MSRB for the Sample Period, the Commission noted that the MSRB received a significant number of event notices for bond calls relative to the event notices for other events. The Commission, however, did not identify any particular trend for this event item in the data that, in its view, would lead to an underestimate of event notices that would be submitted in connection with the amendments. The

discussed in the Proposing Release, the Commission estimated, and continues to believe, that the process for an issuer to prepare and submit event notices to the MSRB in an electronic format will require approximately 45 minutes.<sup>419</sup> Since the amendments to the Rule do not change the way event notices are prepared and submitted, the Commission estimates that an issuer still will require approximately 45 minutes to prepare and submit an event notice. Therefore, under the amendments, the total burden on issuers of municipal securities to prepare and submit 74,605 event notices to the MSRB is estimated to be 55,954 hours.<sup>420</sup> The Commission received comments relating to its estimates to prepare and submit event notice filings generally under the proposed amendments. These comments are addressed in Section V.D.2.b, below

iv. Failure to File Notices

Under the amendment to modify the exemption for demand securities, the Commission estimates that the 12,000 municipal issuers with continuing disclosure agreements will prepare and submit approximately 1,458 failure to file notices yearly.<sup>421</sup> As the Commission discussed in

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Commission's estimates of the number of additional event notices associated with the amendments relating to the materiality condition and number of additional event disclosure items contained in paragraph (b)(5)(i)(C) of the Rule are discussed in Section V.D.2.b, infra. As discussed below, the total number of event notices estimated to be submitted to the MSRB in connection with the amendments is 81,362 notices.

<sup>419</sup> See Proposing Release, supra note 2, 74 FR at 36851-52.

<sup>420</sup> 74,605 (estimated number of event notices under the amendments) x .75 hours (45 minutes) (estimated time to prepare and submit material event notices under the amendments) = 55,953.7 hours (rounded to 55,954 hours). In the Proposing Release, the Commission estimated that municipal issuers would spend 54,000 hours to prepare and submit event notices to the MSRB. The Commission is revising its estimate to 55,954 hours. This estimate is higher than the estimate in the Proposing Release by 1,954 hours or 3.62%.

<sup>421</sup> 1,215 (814 (total number of failure to file notice filings submitted to the MSRB during the Sample Period)/.67 (annualized number failure to file notices submitted to MSRB) x 1.20 (20% increase in filings) = 1,458 failure to file notices (estimated number of failure to file notices under the amendments)). In the Proposing Release, the Commission estimated that issuers would prepare and submit 2,400 failure to file notices. The

the Proposing Release, since the amendments to the Rule will not change the way failure to file notices are prepared and submitted, the Commission estimated, and continues to believe, that an issuer will require approximately 30 minutes to prepare and submit a failure to file notice.<sup>422</sup> Therefore, under the amendments, the total burden on issuers of municipal securities to prepare and submit 1,458 failure to file notices to the MSRB is estimated to be 729 hours.<sup>423</sup> The Commission received no comments on its estimates to prepare and submit failure to file notices and believes that its estimates, as revised to take into account the data provided by the MSRB, are appropriate.

b. Amendments to Event Notice Provisions of the Rule

Under the amendment to paragraph (b)(5)(i)(C) of the Rule, a Participating Underwriter will be required to reasonably determine that an issuer or obligated person has entered into a continuing disclosure agreement that, among other things, provides for the submission of an event notice to the MSRB in an electronic format upon the occurrence of certain specified events, either in each instance that the event occurs or subject to a materiality determination, as set forth in the amended Rule. The amendments also add to the Rule four new event disclosure items and revise an existing event disclosure item. In addition, the amendments to paragraphs (b)(5)(i)(C) and (d)(2)(ii)(B) amend the Rule to provide that a Participating Underwriter must reasonably determine that an issuer of municipal securities or obligated person has undertaken, in

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Commission is revising its estimate to 1,458 failure to file notices. This estimate is lower than the estimate in the Proposing Release by 942 failure to file notices or by 60.75%.

<sup>422</sup> See Proposing Release, supra note 2, 74 FR at 36852.

<sup>423</sup>  $1,458$  (estimated number of failure to file notices under the amendments)  $\times$   $.5$  hours (30 minutes) (estimated time to prepare and submit failure to file notices under the amendments) = 729 hours. In the Proposing Release, the Commission estimated that issuers would spend 1,200 hours to prepare and submit failure to file notices. The Commission is revising its estimate to 729 hours. This estimate is lower than the estimate in the Proposing Release by 471 hours or by 39.25%.

a written agreement or contract for the benefit of holders of municipal securities, to provide event notices in a timely manner “not in excess of ten business days after the occurrence of the event,” rather than simply in a timely manner.

As discussed above, the Commission estimates that the amendment to modify the Rule’s exemption for demand securities will increase the number of event notices to be prepared and submitted to an aggregate of 74,605 event notices annually.<sup>424</sup> The Commission believes that the amendments to paragraphs (b)(5)(i)(C) and (d)(2)(ii)(B) of the Rule also will increase the annual paperwork burden for issuers because of the increase in the number of event notices to be prepared and submitted, as discussed below.<sup>425</sup>

i. Time Frame for Submitting Event Notices under a Continuing Disclosure Agreement

The amendments revise paragraphs (b)(5)(i)(C) and (d)(2)(ii)(B) of the Rule to state that notice of an event should be provided “in a timely manner not in excess of ten business days after the occurrence of the event” instead of simply in “a timely manner.” As noted above, the Commission estimates that an issuer can prepare and submit an event notice in 45 minutes.<sup>426</sup> The amendment to the Rule providing for a ten business day time limit for submission of event notices will not change this estimated burden of 45 minutes, which is the amount of time estimated under the Rule’s previous paperwork collection to prepare and submit event notices. Rather, the overall change in burden results from the fact that more event notices are expected to be filed as a result of the amendments, as discussed in Section V.D.2.a.iii., above.<sup>427</sup>

Several commenters offered their views on the impact of the proposal to establish a ten

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<sup>424</sup> See supra note 418 and accompanying text.

<sup>425</sup> Id.

<sup>426</sup> See supra note 405 and accompanying text.

<sup>427</sup> See supra note 419 and accompanying text.

business day time frame for the submission of event notices.<sup>428</sup> A number of these commenters expressed concern that the requirement would increase the burden for issuers.<sup>429</sup> The concerns expressed by these commenters included: (i) the impracticability of meeting the ten business day time period because of limited staff and resources, especially for smaller issuers;<sup>430</sup> (ii) the increased burdens and costs due to the additional monitoring to comply with the ten business day time frame;<sup>431</sup> (iii) the difficulty in reporting events in which the issuer does not control the information (e.g., rating changes, changes to the trustee, changes to tax status of bonds under an IRS audit) within the ten business day time period;<sup>432</sup> and (iv) the use of the “occurrence of the event” as the trigger for the obligation to submit a notice.<sup>433</sup> Many of these commenters focused their concerns on the potential burdens associated with reporting rating changes within the ten business day time frame.<sup>434</sup> These commenters noted that ratings information is not within the issuer’s control and that rating organizations do not directly notify issuers’ of rating changes.<sup>435</sup>

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<sup>428</sup> See, e.g., Halgren Letter, Los Angeles Letter, Portland Letter, CRRC Letter, WCRRC Letter, NFMA Letter, CHEFA Letter, NAHEFFA Letter, SIFMA Letter, Connecticut Letter, Kutak Letter, ICI II Letter, Fidelity Letter, California Letter, San Diego Letter, NABL Letter, GFOA Letter, and Metro Water Letter.

<sup>429</sup> See Halgren Letter, Los Angeles Letter, CRRC Letter, WCRRC Letter, CHEFA Letter, NAHEFFA Letter, SIFMA Letter, Connecticut Letter, Kutak Letter, California Letter, San Diego Letter, NABL Letter, GFOA Letter, and Metro Water Letter.

<sup>430</sup> See CRRC Letter, WCRRC Letter, Portland Letter at 2, NAHEFFA Letter at 2-4, Metro Water Letter at 1-2, CHEFA Letter at 2, and NABL Letter at 5-6.

<sup>431</sup> See Halgren Letter, Los Angeles Letter at 1, CRRC Letter, WCRRC Letter, NAHEFFA Letter at 2-4, CHEFA Letter at 2, and NABL Letter at 5-6, and 8-9.

<sup>432</sup> See Connecticut Letter at 1-2, California Letter 1-2, San Diego Letter at 1-2, NAHEFFA Letter at 2-4, CHEFA Letter at 2, Kutak Letter at 2, and GFOA Letter at 2-3.

<sup>433</sup> See California Letter at 1-2, NAHEFFA Letter at 2-4, CHEFA Letter at 2, San Diego Letter at 1-2, GFOA Letter at 3, Kutak Letter at 2, and NABL Letter at 5-6.

<sup>434</sup> See Halgren Letter, Los Angeles Letter at 1-2, NAHEFFA Letter at 2-4, San Diego Letter at 1-2, California Letter at 1-2, and GFOA Letter at 3-4.

<sup>435</sup> Id.

a. Discussion of Comments Relating to Impracticability of Meeting Time Frame Due to Limited Staff and Resources, Especially for Smaller Issuers

The Commission has considered commenters' concerns about the potential costs and burdens associated with the ten business day time frame for submission of event notices, especially for smaller issuers with limited staff and resources. As discussed above, the Commission estimates that 12,000 issuers will file 74,605 event notices annually. Thus, an issuer will file on average approximately 6 event notices each year ( $74,605/12,000 = 6.05$ ) and spend a total of approximately 4.5 hours annually on average preparing them.<sup>436</sup> The Commission does not believe that spending approximately 4.5 hours annually on average preparing and submitting event notices would be particularly burdensome for issuers, even those with limited staff and resources.<sup>437</sup>

b. Discussion of Comments Relating to Issuers' Increased Burdens and Costs Due to Additional Monitoring, Lack of Issuer Control Over Events, and Use of "Occurrence of the Events" as the Trigger

The Commission has considered comments that the Commission did not fully account for the increased burdens and costs due to additional monitoring to comply with the ten business day time frame, particularly with respect to rating changes.<sup>438</sup> As noted above, one or more

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<sup>436</sup> The Commission estimates that issuers will spend approximately 45 minutes on average to prepare and submit each event notice. The comments that the Commission received relating to this estimate are discussed below.

<sup>437</sup> The Commission also notes that Rule 15c2-12 currently provides a limited exemption, contained in paragraph (d)(2) of the Rule, which provides that paragraph (b)(5) of the Rule does not apply to a primary offering if the conditions contained therein are met. This limited exemption from the Rule is intended to assist small governmental jurisdictions that issue municipal securities and, as a result of this exemption, most small issuers do not have a paperwork burden under the Rule.

<sup>438</sup> See Halgren Letter, Los Angeles Letter at 1, CRRC Letter, WCRRC Letter, NAHEFFA Letter at 2-4, CHEFA Letter at 2, NABL Letter at 5-6, 13, Connecticut Letter at 3, California Letter at 3, San Diego Letter at 1-2, GFOA Letter at 2, and SIFMA Letter at 3.

commenters believed that the “actual knowledge” of the occurrence of the event should be used as the trigger for the obligation to submit an event notice.<sup>439</sup> These commenters expressed their concerns relatively generally, and in most cases did not present any specific evidence to support their conclusions or alternatives to the Commission’s estimates.

The Commission has considered the comments and believes that most of the events currently specified in paragraph (b)(5)(i)(C) of the Rule, and the additional event items included in the amendments, are significant and should become known to the issuer or obligated person expeditiously.<sup>440</sup> Further, many events, such as payment defaults, tender offers, and bankruptcy filings, generally involve the issuer’s or obligated person’s participation.<sup>441</sup> Other events (e.g., failure of a credit or liquidity provider to perform) are of such importance that an issuer or obligated person likely will become aware of such events,<sup>442</sup> or will expect an indenture trustee, paying agent, or other transaction participant to bring them to the issuer’s or obligated person’s attention within a very short period of time.<sup>443</sup>

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<sup>439</sup> See, e.g., Kutak Letter at 1. See also NAHEFFA Letter, California Letter, San Diego Letter, CHEFA Letter, GFOA Letter, Metro Water Letter, and NABL Letter.

<sup>440</sup> See supra note 372 and accompanying text for a description of events currently contained in Rule 15c2-12(b)(5)(i)(C). See supra Section III.E. for a description of events added to the Rule by these amendments. The only events specified in the Rule that may not be known to an issuer or obligated person expeditiously are rating changes and trustee name changes.

<sup>441</sup> In addition, as the Commission noted in the Proposing Release, involvement of the issuer or obligated person is often required for substitution of credit or liquidity providers; modifications to rights of security holders; release, substitution, or sale of property securing repayment of the securities; and optional redemptions. See Form Indenture and Commentary, National Association of Bond Lawyers, 2000.

<sup>442</sup> For example, as the Commission noted in the Proposing Release, issuers or obligated persons should have direct knowledge of principal and interest payment delinquencies, proposed or final determinations of taxability from the IRS, tender offers that they initiate, and bankruptcy petitions that they file.

<sup>443</sup> The Commission believes that indenture trustees generally would be aware of principal and interest payment delinquencies; material non-payment related defaults; unscheduled

One commenter also expressed concern that the addition of paragraphs (b)(5)(i)(C)(12) of the Rule (pertaining to notices of bankruptcy, insolvency, receivership or similar event of an issuer or obligated person) and (b)(5)(i)(C)(13) of the Rule (pertaining to notices of mergers, consolidations and acquisitions or asset sales with respect to an issuer or obligated person) would impose a burden on issuers to undertake continuous monitoring of obligated persons to determine whether such events occurred unless limited to certain obligated persons and accompanied by a materiality condition.<sup>444</sup> As discussed above,<sup>445</sup> bankruptcies and similar events involving municipal issuers or obligated persons are relatively rare and issuers may avoid directly monitoring obligated persons by obtaining an agreement from them at the time of the primary offering to notify the party responsible for making event notice filings of such an event if and when it occurs.<sup>446</sup> Similar to its discussion regarding bankruptcies and similar events, the Commission believes that there are a variety of methods by which issuers and obligated persons could avoid having to directly monitor the activities of other obligated persons, such as obtaining, at the time of the primary offering, an agreement from them to provide information pertaining to a merger, consolidation, acquisition or similar asset sale to the party responsible for filing event notices.<sup>447</sup>

One commenter believed that the time that would be required for issuers and other

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draws on credit enhancements reflecting financial difficulties; the failure of credit or liquidity providers to perform; and adverse tax opinions. The Commission notes that issuers and obligated persons may wish to consider negotiating a provision in indentures to which they are a party to require a trustee promptly to notify the issuer or obligated person in the event the trustee knows or has reason to believe that an event specified in paragraph (b)(5) of the Rule has or may have occurred.

<sup>444</sup> See NABL Letter at 8-9.

<sup>445</sup> See *supra* Section III.E.2.

<sup>446</sup> *Id.*

<sup>447</sup> *Id.*



obligated persons to establish and implement procedures to provide notice of rating changes within ten business days after their occurrence exceeds the Commission's estimate of 45 minutes per event notice filing.<sup>448</sup> This commenter believed that the Commission's estimates did not include the time necessary to monitor for rating changes, and that issuers would spend 26 to 52 hours per year on such monitoring.<sup>449</sup> Another commenter stated that, during the 2008-2009 fiscal year, it filed 169 separate "material event notices" relating to rating changes and that submission of such notices consumed 340 to 420 hours of staff time.<sup>450</sup> This commenter further believed that the ten business day time frame would exacerbate its burden since it would have to devote more staff time to monitor for rating changes. A third commenter believed that the ten business day time frame for submission of event notices for rating changes would double compliance time.<sup>451</sup>

The Commission notes that issuers and obligated persons, under current continuing disclosure agreements, contract to provide event notices, including those relating to rating changes, "in a timely manner." The amendments add a maximum time frame of ten business days for submission of an event notice, and the Commission acknowledges that some issuers may have to monitor for certain events more frequently than in the past, if they have been interpreting "in a timely manner" as allowing them to submit event notices more than ten business days after the event occurred. The Commission's PRA estimate encompasses the average amount of time spent monitoring for all of the events in the Rule. As noted above, most

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<sup>448</sup> See NABL Letter at 5-6.

<sup>449</sup> Id.

<sup>450</sup> See California Letter at 3. See also San Diego Letter at 2 (expressing similar concern that complying preparing and submitting event notices for rating changes required a "significant commitment of staff time and resources.").

<sup>451</sup> See Halgren Letter at 1.

of the Rule's events, except perhaps rating changes and, in some cases, trustee name changes, should become known to the issuer prior to the event, or immediately or within a short period of time after the event.<sup>452</sup> While the commenters asserted, either generally or based on their own experience, that the Commission underestimated the time required to monitor for rating changes, the Commission emphasizes that the continuing disclosure agreements that issuers enter into under the current Rule already require them to submit notices for rating changes, which necessarily entails some degree of monitoring.<sup>453</sup> Furthermore, information about rating changes is readily available on the Internet Web sites of the rating agencies.

With respect to changes in trustees, the Commission believes that issuers can minimize monitoring burdens simply by adding a notice provision to the trust indenture that requires the trustee to provide the issuer with notice of the appointment of a new trustee or any change in the trustee's name.

The Commission continues to expect that issuers and obligated persons generally will become aware of events subject to event notices well within the ten business day time frame for

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<sup>452</sup> With respect to one commenter's assertion that monitoring for rating changes would take 26-52 hours each year, the Commission notes that 45 minutes per event notice is an average. With respect to the comment that, during the fiscal year 2008-2009, one commenter spent 340-420 hours of staff time preparing and submitting notices of rating changes, the Commission notes that this commenter is one of the very largest municipal securities issuers and, as such, likely has a large number of issues of municipal securities outstanding with a variety of credit ratings that may change at a variety of times. Accordingly, this issuer likely spends much more time than the average issuer preparing and submitting event notices. In addition, the Commission notes that the time period referenced by this commenter encompasses the period prior to the establishment of the MSRB's EMMA system as a single repository for continuing disclosure, when issuers submitted continuing disclosure documents to four information repositories. Accordingly, the Commission would expect that the time spent by the average issuer to monitor for rating changes would be substantially less than the estimate provided by this commenter.

<sup>453</sup> Sec 17 CFR 240.15c2-12.

submission of event notices to the MSRB.<sup>454</sup> The Commission believes that its burden analysis takes into account compliance by issuers with the ten business day time frame for preparing and submitting event notices, including with respect to rating changes and trustee changes. The Commission stresses that its estimate is an average of the burden associated with all event notices referenced in the Rule. Although some issuers may need to monitor more actively for certain events than they have in the past, in particular for ratings changes, the Commission believes its 45 minute estimate continues to reflect, on average, the amount of time required to prepare and submit an event notice, as most event notices concern events that are within the issuer's control and therefore require little if any monitoring.

For the foregoing reasons, the Commission continues to believe that, with respect to the amendment to the Rule regarding the ten business day time frame for submission of event notices, its estimated burden of 45 minutes to prepare and submit an event notice is appropriate.

ii. Modification with regard to Those Events for which a Materiality Determination Is Necessary

As discussed above, the Commission believes that it is appropriate to delete the condition in paragraph (b)(5)(i)(C) of the Rule that previously provided that notice of all of the listed events need be made only "if material." In connection with the deletion of the materiality condition, the Commission reviewed each of the Rule's specified events to determine whether a materiality determination should be retained, and proposed to do so where appropriate.<sup>455</sup> As a

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<sup>454</sup> Those issuers or obligated persons required by Section 13(a) or Section 15(d) of the Exchange Act to report certain events on Form 8-K (17 CFR 249.308) would already make such information public in a Form 8-K. The Commission believes that such persons should be able to file material event notices, pursuant to the issuer's or obligated person's undertakings, within a short time after the Form 8-K filing. See 15 U.S.C. 78m and 78o(d).

<sup>455</sup> The discussion in this section pertains to materiality determinations for events previously specified in paragraph (b)(5)(i)(C) of the Rule. For new events being added to the Rule

result, for those events listed in paragraph (b)(5)(i)(C) for which the materiality condition no longer applies, the Participating Underwriter must reasonably determine that the issuer or other obligated person has agreed to submit event notices to the MSRB whenever such an event occurs. These events include: (1) principal and interest payment delinquencies with respect to the securities being offered; (2) unscheduled draws on debt service reserves reflecting financial difficulties; (3) unscheduled draws on credit enhancements reflecting financial difficulties; (4) substitution of credit or liquidity providers, or their failure to perform; (5) defeasances; and (6) rating changes.<sup>456</sup>

Prior to the Commission's consideration of the Proposing Release, the Commission staff was advised that the total number of event notices as a result of the change to the materiality condition would increase by no more than 1,000, taking into account the revised exemption for demand securities.<sup>457</sup> Thus, in the Proposing Release, the Commission conservatively estimated that this change to the materiality condition would increase the total number of event notices to be submitted annually by issuers by 1,000 notices. The Commission received no comments on this estimate. Although the Commission has slightly increased the total number of continuing disclosure documents it expects the MSRB to receive based on actual submissions the MSRB

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as a result of these amendments, a materiality determination discussion, if any, is included in the applicable section for each new event.

<sup>456</sup> See supra Section III.C.3. for a discussion of the Commission's rationale regarding why it retained a materiality condition for these events.

<sup>457</sup> Telephone conversation between Ernesto A. Lanza, General Counsel, MSRB, and Martha M. Haines, Assistant Director and Chief, Office of Municipal Securities, Division, Commission, June 12, 2009. As noted in the Proposing Release, although the MSRB staff believed that the potential increase could be much smaller, the Commission is continuing to use the estimate of 1,000 event notices to provide a conservative estimate. See Proposing Release, supra note 2, 74 FR at 36853.

received during the Sample Period,<sup>458</sup> it continues to believe that its estimate of 1,000 notices in connection with a change to the materiality condition is appropriate.

Several commenters offered their views on the impact of the proposal to delete the condition in paragraph (b)(5)(i)(C) of the Rule that previously provided that notice of all of the listed events need be made only "if material."<sup>459</sup> Two of these commenters expressed concern that this change would increase the burden for issuers, but did not specify whether the Commission's estimate of increased burdens was inaccurate, or offer an alternative estimate.<sup>460</sup>

One commenter believed that the proposal to delete the "if material" qualification could burden issuers in certain circumstances.<sup>461</sup> Another commenter believed the deletion of the materiality condition would increase monitoring burdens and require disclosure of events that otherwise would not be disclosed.<sup>462</sup> These commenters, however, did not specifically call into question whether the Commission's burden estimate, or offer an alternative estimate. The Commission has reviewed its estimates in light of commenters' views and believes that they do not reflect any new or additional burden that is not contemplated by the Commission's estimates.

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<sup>458</sup> See supra Section V.D.2.

<sup>459</sup> See, e.g., NABL Letter, Metro Water Letter, California Letter, ICI Letter, and SIFMA Letter.

<sup>460</sup> See NABL Letter and Metro Water Letter.

<sup>461</sup> See NABL Letter at 6-7. The three circumstances where the commenter believes a materiality qualifier should be retained are: (1) with respect to LOC-backed demand securities, notices of unscheduled draws on debt service reserves that reflect financial difficulties of the obligated person because they might not be material to an investment in the securities because they are traded on the strength of a bank letter of credit; (2) with respect to demand securities, generally, require notice of each failure to remarket securities when they are put, because they might not be material to an investor due to the existence of a letter of credit or other liquidity facility; and (3) notice of defeasances of securities, because they might not be material to an investor if the remaining term of the securities is very short.

<sup>462</sup> See Metro Water Letter at 2.

iii. Amendment to the Submission of Event Notices Regarding Adverse Tax Events under a Continuing Disclosure Agreement

Paragraph (b)(5)(i)(C)(6) of the Rule contemplates an event notice in the case of certain adverse tax events. Under the amendments, paragraph (b)(5)(i)(C)(6) of the Rule refers specifically to “adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the securities, or other material events affecting the tax status of the security.” As discussed above,<sup>463</sup> the Commission believes that the amendment to paragraph (b)(5)(i)(C)(6) of the Rule clarifies that IRS proposed and final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of a municipal security are events that should be disclosed under a continuing disclosure agreement. As discussed in the Proposing Release, the Commission estimated that the amendment to paragraph (b)(5)(i)(C)(6) of the Rule would increase the total number of event notices to be submitted by issuers annually by approximately 130 notices.<sup>464</sup>

As described in greater detail above, the Commission is making a few changes to the proposed text of the Rule to clarify the use of the word “material” in this event item and to replace the phrase “tax-exempt status” with “tax status” to provide greater clarity with respect to the application of this disclosure event to a particular kind of taxable municipal security. The

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<sup>463</sup> See supra Section III.D.

<sup>464</sup> Prior to the Commission’s consideration of the proposed amendments, in conversations with the Commission staff in December 2008, the staff of the IRS indicated that during a 12-month period it issues approximately 130 notices of determinations of taxability. See Proposing Release, supra note 2, 74 FR at 36853, n. 188.

Commission does not believe that these changes will affect its estimate of 130 additional event notices.

As discussed in Section III.D above, several commenters offered their views on the impact of the proposal to amend the Rule to include “the issuance by the IRS of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax-exempt status of the securities, or other events affecting the tax exempt status of the security.”<sup>465</sup> One commenter noted that the municipal market may be flooded with notices due to the generality and vagueness of the proposed tax disclosure items, but did not specifically call into question the Commission’s burden estimate or offer an alternative estimate.<sup>466</sup> In addition, none of the other commenters specifically called into question the Commission’s estimate of 130 additional notices. The Commission has reviewed its estimate in light of these comments and believes that its estimate of 130 notices for this disclosure event item remains appropriate.

iv. Tender Offers

Paragraph (b)(5)(i)(C)(8) of the Rule refers to notice of an event in the case of bond calls. Paragraph (b)(5)(i)(C)(8) of the Rule is amended to include tender offers as a disclosure event. The inclusion of tender offers as an event item expands the circumstances in which issuers undertake to submit an event notice to the MSRB. As discussed in the Proposing Release, the Commission estimated that this amendment would increase the total number of event notices to

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<sup>465</sup> See, e.g., Connecticut Letter at 2, Metro Letter at 2, NABL Letter at 7, Kutak Letter at 5-6, and GFOA Letter at 2.

<sup>466</sup> See Kutak Letter at 4-7.

be submitted by issuers annually by approximately 100 notices.<sup>467</sup> The Commission received no comments on this estimate and continues to believe that this estimate is appropriate.

v. The Occurrence of Bankruptcy, Insolvency, Receivership or Similar Event of the Obligated Person

Under the amendments, paragraph (b)(5)(i)(C)(12) is being added to the Rule to provide for the submission of an event notice in the case of bankruptcy, insolvency, receivership or similar event of the obligated person. Adding bankruptcy, insolvency, receivership or similar event of the obligated person as a disclosure event expands the circumstances in which obligated persons undertake to submit an event notice to the MSRB. Based on industry sources, the Commission estimated in the Proposing Release that this amendment would increase the total number of event notices submitted by obligated persons annually by approximately 24 notices.<sup>468</sup>

Several commenters offered their views on the impact of the proposal to add bankruptcy, insolvency, receivership or similar event of the obligated person as a new disclosure event.<sup>469</sup> One of these commenters expressed concern that the event item, unless revised, could increase

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<sup>467</sup> See Proposing Release, *supra* note 2, 74 FR at 36853. Based on industry sources that include lawyers, trade associations and vendors of municipal disclosure information, the Commission estimated that there are typically no more than 100 tender offers annually in the municipal securities market.

<sup>468</sup> This estimate was based on the following: (i) 917 (number of issuances of municipal securities that defaulted during the 1990s based on statistics contained in Standard and Poor's "A Complete Look at Monetary Defaults in the 1990s" (June, 2000)) / 10 (number of years in a decade) = 91.7 (estimated number of issuances defaulting per year) (rounded to 92); (ii) 92 (estimated number of issuances defaulting per year) / 50,000 (estimated total number of municipal issuers) = .002 (.2 %) (estimated percentage of all issuers that default annually); and (iii) 12,000 (estimated number of issuers under amendments to the Rule) x (.002) (.2%) (estimated percentage of all issuers that default annually) x 1 (estimated number of material event notices that an issuer will file) = 24 notices. The Commission notes that not all issuers or obligated persons that default eventually enter bankruptcy so the number of actual notices may be less.

<sup>469</sup> See Connecticut Letter at 2, GFOA Letter at 4, Metro Water Letter at 2, and NABL Letter at 8.



the burdens for issuers to engage in continuous monitoring of obligated persons in certain circumstances.<sup>470</sup> The Commission has discussed this comment in Sections III.E.2 and V.D.2.b, above. None of these commenters, however, called into question the Commission's estimate of 24 additional event notices or offered an alternative estimate. The Commission has reviewed its estimate in light of these comments and believes that its estimate of 24 notices for this disclosure event remains appropriate.

vi. Merger, Consolidation, Acquisition, or Sale of All or Substantially All Assets

Under the amendments, paragraph (b)(5)(i)(C)(13) is being added to the Rule to provide for the submission of event notices in the case of a merger, consolidation, acquisition involving an obligated person or sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material. The addition to the Rule of this disclosure event will expand the circumstances in which issuers will undertake to submit an event notice to the MSRB. The Commission believes that this amendment will increase the total number of event notices submitted by issuers annually. Based on industry sources, the Commission estimated in the Proposing Release that adding the new event item in paragraph (b)(5)(i)(C)(13) of the Rule would increase the total number of event notices submitted by issuers annually by approximately 1,783 notices.<sup>471</sup>

<sup>470</sup> See NABL Letter at 8.

<sup>471</sup> See Proposing Release, *supra* note 2, 74 FR at 36853. This estimate was based on the following: (i) 2,201 (total number of merger transactions reported under the Hart-Scott-Rodino Act in 2007 contained in the Hart-Scott-Rodino Annual Report Fiscal Year 2007 (November 2008) available at <http://www.ftc.gov/os/2008/11/hsrreportfy2007.pdf> ("HSR Report") x 81% (percentage of mergers in industries in which municipal securities

Several commenters offered their views on the impact of the proposal to add a new disclosure event in the case of a merger, consolidation, acquisition or sale of all or substantially all assets.<sup>472</sup> One of these commenters expressed concern that the event item, unless revised, could increase the burdens for issuers to engage in continuous monitoring of obligated persons in certain circumstances.<sup>473</sup> The Commission has discussed this comment in Sections III.E.3 and V.D.2.b, above. None of these commenters, however, called into question the Commission's estimate of 1,783 additional event notices, or offered an alternative estimate. The Commission has reviewed its estimate in light of these comments and believes that its estimate of 1,783 notices for this disclosure event remains appropriate.

vii. Successor or Additional Trustee, or Change in Trustee Name

Under the amendments, paragraph (b)(5)(i)(C)(14) is being added to the Rule to provide for the submission of an event notice in the case of the appointment of a successor or additional trustee or the change of name of a trustee, if material. Adding this event item to the Rule expands the circumstances in which issuers undertake to submit an event notice to the MSRB. As the Commission noted in the Proposing Release, the Commission believes that trustee changes occur infrequently and a change affecting the largest trustee of municipal securities

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may exist) = 1782.81 notices (rounded to 1783). The estimate of the percentage of mergers in the municipal industry was based on data contained in the HSR Report. The HSR Report contained data regarding the percentage of merger transactions reported from nine industry segments. Of these nine segments, the only segment that does not issue municipal securities is banking and insurance, which accounted for 19% of reported merger transactions. As discussed in the Proposing Release, the Commission notes that each of the mergers reported under the other industry segments may not involve entities that have issued municipal securities so the number of affected municipal securities issuers may be less.

<sup>472</sup> See Kutak Letter at 4, NFMA Letter at 2, SIFMA Letter at 4, Connecticut Letter, GFOA Letter at 4, ICI Letter at 8-9, Fidelity Letter at 3, CRRRC Letter at 5, and WCRRC Letter.

<sup>473</sup> See NABL Letter at 8.

provides a reasonable and conservative estimate of the number of additional event notices that will be submitted annually under this amendment to the Rule.<sup>474</sup> The largest trustee was involved in approximately 31% of the municipal issuances in 2008,<sup>475</sup> and the Commission continues to believe that this represents a reasonable estimate of the percentage of issuers covered by the largest trustee. Thus, the Commission estimates that a change to the largest trustee will impact approximately 31%, or 3,720 issuers. The Commission believes this serves as a conservative proxy for the number of event notices to be submitted regarding a change in trustee.<sup>476</sup> Therefore, the Commission estimates that adding the new event item contained in paragraph (b)(5)(i)(C)(14) of the Rule will increase the total number of event notices submitted by issuers annually by approximately 3,720 notices.<sup>477</sup>

Two commenters expressed concern regarding the increased costs and burdens that some issuers would incur to report changes pertaining to trustees within the Rule's ten business day time frame.<sup>478</sup> These comments are addressed in Section V.D.2.b, above. None of these commenters, however, called into question the Commission's estimate of 3,720 notices, or

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<sup>474</sup> See Proposing Release, *supra* note 2, 74 FR at 36854.

<sup>475</sup> See Two Decades of Bond Finance: 1989-2008, The Bond Buyer/Thomson Reuters 2009 Yearbook 7 (Matthew Kreps ed., SourceMedia, Inc.) (2009) and Top 50 Trustee Banks: 2008, The Bond Buyer/Thomson Reuters 2009 Yearbook 89 (Matthew Kreps ed., SourceMedia, Inc.) (2009).

<sup>476</sup> This estimate is based on the following: 12,000 (estimated number of issuers under amendments) x .31 (31%) (estimated percentage of issuers that would be impacted by a change to the largest trustee of municipal securities) = 3,720 issuers.

<sup>477</sup> This estimate is based on the following: 3,720 (estimated number of issuers that will be impacted by a change to the largest trustee of municipal securities) x 1 (estimated number of event notices that an issuer will file) = 3,720 notices. The Commission believes that the actual number of changes involving the trustee, which occur annually, is likely to be significantly less than 3,720. However, to provide a conservative estimate for the paperwork burden, the estimate takes into account a change involving the largest trustee.

<sup>478</sup> See CHEFA Letter at 3 and NAHEFFA Letter at 4.

offered an alternative estimate. The Commission has reviewed its estimate in light of these comments and believes that its estimate of 3,720 notices for this disclosure event remains appropriate.

c. Total Burden on Issuers for Amendments to Event Notices

In the Proposing Release, the Commission estimated and continues to believe that the process for an issuer to prepare and submit event notices to the MSRB in an electronic format will require approximately 45 minutes.<sup>479</sup> As discussed above, the amendment to modify the Rule's exemption for demand securities will increase total number of issuers affected by the Rule to 12,000 issuers,<sup>480</sup> the total number of event notices submitted by issuers to 74,605 notices,<sup>481</sup> and the annual paperwork burden for issuers to submit event notices to 55,954 hours.<sup>482</sup>

Under the amendments to paragraph (b)(5)(i)(C) of the Rule, the Commission estimates that the 12,000 municipal issuers with continuing disclosure agreements will prepare an additional 6,757 event notices annually,<sup>483</sup> raising the total number of event notices prepared by issuers annually to approximately 81,362.<sup>484</sup> This increase in the number of event notices will

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<sup>479</sup> See Proposing Release, supra note 2, 74 FR at 36851.

<sup>480</sup> See supra note 375.

<sup>481</sup> See supra note 418.

<sup>482</sup> See supra note 420.

<sup>483</sup> 1,000 (estimated number of additional notices due to change to materiality condition) + 130 (estimated number of additional adverse tax event notices) + 100 (estimated number of tender offers event notices) + 24 (estimated number of bankruptcy/insolvency event notices) + 1,783 (estimated number of merger or acquisition event notices) + 3,720 (estimated number of appointment/change of trustee event notices) = 6,757 (total estimated number of additional event notices that will be prepared under the amendments). See also Proposing Release, supra note 2, 74 FR at 36854.

<sup>484</sup> 72,000 (number of event notices estimated under the Rule under the amendments modifying the exemption for event notices in the Proposing Release) + 2,605 (revised number of event notices under amendments modifying the exemption for demand securities exemption) + 6,757 (total number of additional event notices that will be

result in an increase of 5,068 hours in the annual paperwork burden for issuers to submit event notices.<sup>485</sup> In total, the amendments will result in an annual paperwork burden of approximately 61,022 hours (55,954 hours + 5,068 hours) for issuers to submit notices to the MSRB.

d. Total Burden for Issuers

Accordingly, under the amendments, the total burden on issuers to submit annual filings, event notices and failure to file notices will be 78,933 hours.<sup>486</sup>

3. MSRB

As discussed in the Proposing Release, the Commission estimated, and continues to believe, that the MSRB will incur an annual burden of approximately 7,000 hours to collect, index, store, retrieve, and make available the pertinent documents under the Rule.<sup>487</sup> The Commission anticipates that the amendment to modify the Rule's exemption for demand securities will increase filings to the MSRB by approximately 20% annually.<sup>488</sup> In addition, the Commission estimates that the amendments to the event notice provisions of the Rule will

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prepared under the amendments to the event notice provisions of the Rule) = 81,362 event notices. This estimate is higher than the estimate in the Proposing Release by 2,605 filings or 3.31%. See supra notes 418, 483, and accompanying text.

<sup>485</sup> 6,757 (total number of additional event notices that will be prepared under the amendments to the event notice provisions of the Rule) x .75 hours (45 minutes) (estimated time to prepare an event notice) = 5,067.75 hours (rounded to 5,068 hours). See supra note 483 and accompanying text.

<sup>486</sup> 17,182 hours (estimated burden for issuers to submit annual filings) + 61,022 hours (estimated burden for issuers to submit event notices) + 729 hours (estimated burden for issuers to submit failure to file notices) = 78,933 hours. This estimate is higher than the estimate in the Proposing Release by 5,165 hours or 7%. See supra notes 417, 420, 423, 485 and accompanying text.

<sup>487</sup> See Proposing Release, supra note 2, 74 FR at 36854. This estimate is further described in the Commission's 2008 PRA submission. See 2008 PRA submission, supra note 374.

<sup>488</sup> See supra note 402 and accompanying text.

increase filings submitted by to the MSRB approximately 9% annually.<sup>489</sup> Accordingly, the Commission estimates that the total burden on the MSRB of collecting, indexing, storing, retrieving and disseminating information requested by the public also will increase by approximately 29% (20% + 9%) or 2,030 hours (7,000 hours x .29). Thus, the Commission estimates that the total burden on the MSRB as a result of the amendments will be 9,030 hours annually.<sup>490</sup> The Commission included these estimates in the Proposing Release and received no comments on them. The Commission continues to believe that these estimates are appropriate.

#### 4. Annual Aggregate Burden for Amendments

The Commission estimates that, as a result of the amendments, the ongoing annual aggregate information collection burden under the Rule will be 88,263 hours.<sup>491</sup>

#### E. Total Annual Cost Burden

##### 1. Broker-Dealers and the MSRB

The Commission does not expect broker-dealers to incur any additional external costs associated with the amendments since there is no change to the obligation of broker-dealers under the Rule to reasonably determine that the issuer or obligated person has undertaken, in a written agreement or contract for the benefit of holders of such municipal securities, to provide

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<sup>489</sup>  $6,757$  (estimated additional event notices under the final event notice amendments) /  $77,000$  (estimated number of continuing disclosure documents submitted under the Rule prior to the amendments (60,000 (event notices) + 15,000 (annual filings) + 2,000 (failure to file notices) = 77,000)) =  $.087 \times 100$  = approximately 9%. For additional information regarding PRA estimates related to Rule 15c-12 prior to the amendments, including the estimate of 77,000, see 2008 PRA submission, supra note 374.

<sup>490</sup> Annual burden for MSRB: 7,000 hours (annual burden under the Rule prior to the amendments) + 2,030 hours (additional hourly burden under amendments) = 9,030 hours.

<sup>491</sup> 300 hours (total estimated burden for broker-dealers) + 78,933 hours (total estimated burden for issuers) + 9,030 hours (total estimated burden for MSRB) = 88,263 hours. This estimate is higher than the estimate in the Proposing Release by 5,165 hours or 6.22%.

annual filings, event notices, and failure to file notices to the MSRB. The Commission included this cost burden estimate in the Proposing Release and received no specific comments on it. However, the Commission received one comment relating to broker-dealers' costs under the Rule.<sup>492</sup> This commenter believed that the Commission underestimated the additional burdens and costs that the amendments would impose on Participating Underwriters to review disclosure about obligated persons in offerings for demand securities, unless the amendments to the Rule were clarified for offerings of LOC-backed demand securities.<sup>493</sup>

In the Proposing Release, the Commission solicited comment regarding the accuracy of its cost burden estimates in connection with the revised collection of information that would apply to broker-dealers.<sup>494</sup> Although the commenter noted above provided general comments relating to broker-dealers' burdens and costs under the Rule, which are addressed in Section V.D.1.a, it did not offer specific information or data that conflicts with the Commission's estimates nor did it provide alternative estimates. Also, this commenter made a similar statement with respect to burdens on issuers with respect to demand securities, which the Commission addressed in Section V.D.2.a.i above, and its response is also applicable here.

In addition, the Commission believes that the MSRB may incur costs to modify the indexing system of its EMMA system to accommodate the amendments to the Rule that incorporate additional disclosure events. As discussed in the Proposing Release, based on information provided to the Commission staff by MSRB, the Commission estimated that the MSRB's costs to update its EMMA system to accommodate the new or revised disclosure events

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<sup>492</sup> See NABL Letter.

<sup>493</sup> See NABL Letter at 12-13.

<sup>494</sup> See Proposing Release, supra note 2, 74 FR at 36858.

would be no more than approximately \$10,000.<sup>495</sup> The Commission also included this cost estimate in the Proposing Release and received no comments on it. The Commission continues to believe that this estimate is appropriate.

2. Issuers

a. Current Issuers

The Commission expects that some issuers that already submit continuing disclosure documents to the MSRB in an electronic format (referred to herein as “current issuers”) may be subject to some costs associated with the amendments to the Rule. For current issuers that convert their annual filings, event notices and/or failure to file notices into the MSRB’s prescribed electronic format through a third party, there will be costs associated with any additional submissions of event notices and failure to file notices.

The cost for an issuer to have a third-party vendor convert paper continuing disclosure documents into the MSRB’s prescribed electronic format may vary depending on what resources are required to transfer the documents into the appropriate electronic format. One example of such a transfer would be the scanning of paper-based continuing disclosure documents into an electronic format. As discussed in the Proposing Release, the Commission estimated that the cost for an issuer to have a third-party vendor scan documents would be \$6 for the first page and \$2 for each page thereafter.<sup>496</sup> The Commission also estimated that event notices and failure to file notices consist of one to two pages.<sup>497</sup> Accordingly, the approximate cost for an issuer to use

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<sup>495</sup> See Proposing Release, supra note 2, 74 FR at 36855, n. 205. Telephone conversation between Harold Johnson, Deputy General Counsel, MSRB, and Martha M. Haines, Assistant Director and Chief, Office of Municipal Securities, Division, Commission, November 7, 2008.

<sup>496</sup> See Proposing Release, supra note 2, 74 FR at 36855.

<sup>497</sup> Id.



a third-party vendor to scan an event notice or failure to file notice would be \$8 per notice. The Commission included this cost estimate in the Proposing Release and received no comments on it. The Commission believes that this estimate is still accurate.

In addition, the Commission estimated that an issuer submits three event notices to the MSRB annually.<sup>498</sup> As discussed above, the Commission recently received updated information from the MSRB relating to the actual number of annual filings, event notices and failure to file notices submitted to its EMMA system during the Sample Period. Based on this information from the MSRB, the Commission is updating its PRA estimates of the total number of event notices that will be submitted by issuers. The Commission also is updating its estimate to reflect that an issuer on average will submit five event notices to the MSRB annually plus an additional notice as a result of the new event items.<sup>499</sup> Under the amendments, some current issuers will need to prepare additional event notices for submission to the MSRB. Some current issuers may need to submit these additional event notices to a third party for conversion into an electronic format for submission to the MSRB. The Commission estimated that the number of additional event notices that an issuer will need to submit annually under the amendments is one, increasing the total estimate to six notices per year.<sup>500</sup> Each of these issuers will incur an annual cost of \$8 to convert the additional event notice into an electronic format for submission to the MSRB.<sup>501</sup>

The Commission believes that current issuers that already have the technological resources to

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<sup>498</sup> Id.

<sup>499</sup> See discussion of estimate of the average number of event notices to be submitted by each issuer, supra Section V.D.2.b.

<sup>500</sup>  $6,757$  (estimated additional event notices submitted under amendments) /  $12,000$  (estimated number of issuers under amendments) =  $.563$  notices per issuer (rounded up to 1) (estimated number of additional event notices submitted annually per issuer).

<sup>501</sup>  $\$8$  (cost to have third party convert an event notice or failure to file notice into an electronic format) x 1 (estimated number of additional event or failure to file notices filed per year per issuer) =  $\$8$ .

convert continuing disclosure documents into an electronic format for submission to the MSRB will not incur any additional external costs associated with the amendments. The Commission included this \$8 cost estimate in the Proposing Release and received no comments on it.

As the Commission noted in the Proposing Release, there may be some costs incurred by issuers to revise their current template for continuing disclosure agreements to reflect the amendments to the Rule.<sup>502</sup> The Commission understands that models currently exist for continuing disclosure agreements that are relied upon by legal counsel to issuers and, accordingly, these documents are likely to be updated by outside attorneys to reflect the amendments. Based on industry sources and as discussed in the Proposing Release, the Commission believes that continuing disclosure agreements are form agreements.<sup>503</sup> Additionally, based on industry sources, the Commission estimates that it will take an outside attorney approximately 15 minutes to revise the template for continuing disclosure agreements for a current issuer.<sup>504</sup> Thus, the Commission estimates that, for each current issuer, the approximate cost to revise a continuing disclosure agreement to reflect the amendments will be approximately \$100,<sup>505</sup> for a one-time total cost of \$1,000,000<sup>506</sup> for all current issuers. The

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<sup>502</sup> See Proposing Release, supra note 2, 74 FR at 36855.

<sup>503</sup> Id.

<sup>504</sup> Id. Continuing disclosure agreements are prepared and executed at the time of an offering of municipal securities, when an issuer has already retained bond counsel for other purposes. Accordingly, the Commission believes that there should only be minimal incremental costs for an outside attorney to revise the template for continuing disclosure agreements.

<sup>505</sup> 1 (continuing disclosure agreement) x \$400 (hourly wage for an outside attorney) x .25 hours (estimated time for outside attorney to revise a continuing disclosure document in accordance with the amendments to the Rule) = \$100. The \$400 per hour estimate for an outside attorney's work is based on industry sources.

<sup>506</sup> \$100 (estimated cost to revise a continuing disclosure agreement in accordance with the amendments to the Rule) x 10,000 (number of current issuers) = \$1,000,000.

Commission included these cost estimates in the Proposing Release and received no specific comments on them.

b. Demand Securities Issuers

As discussed above, the Commission estimates that the amendments relating to demand securities will increase the number of issuers affected by the Rule by approximately 20% or 2,000 issuers or obligated persons (referred to herein as “demand securities issuers”).<sup>507</sup> As discussed in the Proposing Release, demand securities issuers may have some external costs associated with the preparation and submission of annual filings, event notices and failure to file notices.<sup>508</sup>

Under the Rule, Participating Underwriters are required to reasonably determine that an issuer has entered into a continuing disclosure agreement to provide continuing disclosure documents to the MSRB in an electronic format as prescribed by the MSRB. Under the amendments, Participating Underwriters will need to reasonably determine that these demand securities issuers have entered into continuing disclosure agreements. This change applies to any initial offering and remarketing that is a primary offering of demand securities occurring on or after the compliance date of the amendments.<sup>509</sup> However, to accommodate commenters’ concerns about the proposal’s impact on existing demand securities, the amendment does not apply to remarketings of demand securities that are outstanding in the form of demand securities on the day preceding the amendments’ compliance date and that continuously have remained outstanding in the form of demand securities.

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<sup>507</sup> See supra Section V.D.2.a.

<sup>508</sup> See supra note 402 and accompanying text.

<sup>509</sup> As noted above, the compliance date of the amendments to the Rule is December 1, 2010.

The Commission understands that models currently exist for continuing disclosure agreements that are relied upon by legal counsel to issuers and, accordingly, these documents are likely to be updated by outside attorneys to reflect the amendments. Based on industry sources, the Commission believes that continuing disclosure agreements are form agreements. Also, based on industry sources, the Commission estimates that it will take an outside attorney approximately 1.5 hours to draft a continuing disclosure agreement. Thus, the Commission estimates that the cost of preparing a continuing disclosure agreement for each demand securities issuer will be approximately \$600,<sup>510</sup> for a one-time total cost of \$1,200,000<sup>511</sup> for all demand securities issuers, if an outside counsel prepares the agreement. The Commission included these estimates in the Proposing Release and did not receive any comments on them. The Commission continues to believe they are appropriate.

The Commission believes that demand securities issuers generally will not incur any other external costs associated with the preparation of annual filings, event notices (including notices for the new event disclosure items included in the amendments) and failure to file notices. The Commission believes that demand securities issuers will prepare the information contained in these continuing disclosure documents internally and that these internal costs have been accounted for in the hourly burden section above.<sup>512</sup>

The Commission believes that the only external costs demand securities issuers may incur in connection with the submission of continuing disclosure documents to the MSRB will be

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<sup>510</sup> 1 (continuing disclosure agreement) x \$400 (hourly wage for an outside attorney) x 1.5 hours (estimated time for outside attorney to draft a continuing disclosure document) = \$600. The \$400 per hour estimate is based on industry sources. See supra note 504.

<sup>511</sup> \$600 (cost for continuing disclosure agreement) x 2,000 (number of demand securities issuers) = \$1,200,000.

<sup>512</sup> See supra Section V.D.2.a.

the costs associated with converting them into an electronic format. The Commission believes that many issuers of municipal securities already have the computer equipment and software necessary to convert paper copies of continuing disclosure documents to electronic copies and to electronically transmit the documents to the MSRB. Demand securities issuers that presently do not have the ability to prepare their annual filings, event notices or failure to file notices in an electronic format may incur some costs to obtain electronic copies of such documents if they are prepared by a third party (e.g., an accountant or attorney) or, alternatively, to have a paper copy converted into an electronic format. These costs may vary depending on how the demand securities issuer elects to convert its continuing disclosure documents into an electronic format. An issuer could elect to have a third-party vendor transfer its paper continuing disclosure documents into the appropriate electronic format. An issuer also could decide to undertake the work internally, and its costs may vary depending on the issuer's current technological resources. An issuer also could elect to use a designated agent to submit its continuing disclosure documents to the MSRB.

As discussed in the Proposing Release, the Commission estimated that 30% of issuers would elect to use designated agents to submit continuing disclosure documents to the MSRB.<sup>513</sup> Generally, when issuers utilize the services of a designated agent, they enter into a contract with the agent for a package of services, including the submission of continuing disclosure documents, for a single fee. Based on industry sources, the Commission estimated this fee to range from \$100 to \$500 per year depending on the designated agent an issuer uses.<sup>514</sup> Accordingly, the Commission estimated that the high end of the total annual cost that may be

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<sup>513</sup> See Proposing Release, *supra* note 2, 74 FR at 36856.

<sup>514</sup> This estimated range of the annual fee for the services of a designated agent is based on industry sources in December 2008.

incurred by demand securities issuers that use the services of a designated agent will be \$300,000.<sup>515</sup> The Commission included these estimates in the Proposing Release and received no comments on them. The Commission continues to believe they are appropriate.

The cost for an issuer to have a third-party vendor convert its paper continuing disclosure documents into an appropriate electronic format may vary depending on the type of resources that are required. One method would be to scan paper-based continuing disclosure documents into an electronic format. As discussed in the Proposing Release, the Commission estimated that the approximate cost for an issuer to use a third-party vendor to scan an event notice or failure to file notice would be \$8 per notice, and that the maximum number of event notices or failure to file notices that an issuer would submit annually is three.<sup>516</sup> The Commission included these estimates in the Proposing Release and received no comments on them. As discussed above, the Commission now estimates that an issuer will file five event notices. The Commission believes that these estimates are appropriate. Under the amendments, the Commission estimates that the maximum number of event notices and failure to file notices submitted by issuers will increase to six.<sup>517</sup> Accordingly, the Commission estimates that the maximum external costs for a demand

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<sup>515</sup> 2,000 (number of demand securities issuers) x .30 (percentage of issuers that use designated agents) x \$500 (estimated annual cost for issuer's use of a designated agent) = \$300,000.

<sup>516</sup> See Proposing Release, supra note 2, 74 FR at 36856.

<sup>517</sup> 6,757 (estimated additional event notices submitted under the amendments) / 12,000 (estimated number of issuers under the amendments) = .563 notices per issuer (rounded up to 1) (estimated number of additional event notices submitted annually per issuer). To provide a conservative estimate, the Commission estimates that each issuer will submit one additional event notice as a result of the amendments.

securities issuer that elects to have a third party scan continuing event notices or failure to file notices into an electronic format under the amendments is \$48.<sup>518</sup>

As discussed in the Proposing Release, the Commission estimated that the approximate cost for an issuer to use a third-party vendor to scan an average-sized annual financial statement would be \$64 per annual statement, and that the maximum number of annual filings submitted per year is two.<sup>519</sup> The Commission included these estimates in the Proposing Release and received no comments on them. The Commission continues to believe that these estimates are appropriate. Although the amendments will increase the number of issuers submitting annual filings each year, the number of annual filings each issuer submits will not increase. Thus, the Commission expects that the number of annual filings submitted yearly, per issuer, under the amendments will remain unchanged. Accordingly, the Commission estimates that the maximum external costs for a demand securities issuer that elects to have a third party scan its annual filings into an electronic format will be \$128.<sup>520</sup>

Alternatively, a demand securities issuer that currently does not have the appropriate technology to convert paper continuing disclosure documents into an electronic format could elect to purchase the necessary resources to do so.<sup>521</sup> As discussed in the Proposing Release, the

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<sup>518</sup> The maximum cost is the cost to scan and convert six event or failure to file notices: 6 (number of notices submitted annually) x \$8 (cost to scan and convert each notice) = \$48.

<sup>519</sup> See Proposing Release, supra note 2, 74 FR at 36856.

<sup>520</sup> The maximum cost is the cost to scan and convert two annual filings: 2 (number of annual filings submitted annually) x \$64 (cost to scan and convert each annual filing) = \$128.

<sup>521</sup> Generally, the technological resources necessary to convert a paper document into an electronic format are a computer, scanner and possibly software to convert the scanned document into the appropriate electronic document format. Most scanners include a software package that is capable of converting scanned images into multiple electronic document formats. An issuer would only need to purchase software if the issuer (i) has a scanner that does not include a software package that is capable of converting scanned

Commission estimated that an issuer's initial cost to acquire these technological resources could range from \$750 to \$4,300.<sup>522</sup> Some demand securities issuers, however, may have the necessary hardware to transmit documents electronically to the MSRB, but may need to upgrade or obtain the software necessary to submit documents to the MSRB in an electronic format. In the Proposing Release, the Commission estimated that an issuer's cost to update or acquire this software could range from \$50 to \$300.<sup>523</sup> The Commission included these estimates in the Proposing Release and received no comments on them. The Commission continues to believe that these estimates are appropriate.

In addition, demand securities issuers without direct Internet access may incur some costs to obtain such access to submit the documents. As discussed in the Proposing Release, the Commission noted that Internet access is now broadly available to and utilized by businesses, governments, organizations and the public, and the Commission expects that most issuers of municipal securities currently have Internet access.<sup>524</sup> In the event that a demand securities issuer does not have Internet access, it may incur costs in obtaining such access, which the Commission estimated to be approximately \$50 per month, based on its limited inquiries to Internet service providers.<sup>525</sup> Otherwise, there are multiple free or low cost locations that an issuer could utilize, such as various commercial sites, which could help an issuer to avoid the

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images into the appropriate electronic format; or (ii) purchases a scanner that does not include a software package capable of converting documents into the appropriate electronic format.

<sup>522</sup> See Proposing Release, supra note 2, 74 FR at 36857.

<sup>523</sup> Id.

<sup>524</sup> Id.

<sup>525</sup> Id.



costs of maintaining continuous Internet access solely to comply with the amendments.<sup>526</sup> The Commission included this estimate in the Proposing Release and received no comments on it. The Commission continues to believe that this estimate is appropriate.

The Commission estimated in the Proposing Release that the costs to some of the demand securities issuers to acquire the technology necessary to convert continuing disclosure documents into an electronic format to submit to the MSRB may include: (i) approximately \$8 per notice to use a third-party vendor to scan an event notice or failure to file notice, and approximately \$64 to use a third-party vendor to scan an average-sized annual financial statement; (ii) approximately \$750 to \$4,300 to acquire the technological resources to convert continuing disclosure documents into an electronic format; (iii) approximately \$50 to \$300 solely to upgrade or acquire the software to submit documents in an electronic format; and (iv) approximately \$50 per month to establish Internet access. The Commission included these estimates in the Proposing Release and received no comments on them. The Commission continues to believe that they are appropriate.<sup>527</sup>

For a demand securities issuer that does not have Internet access and elects to have a third party convert continuing disclosure documents into an electronic format ("Category 1"), the estimated total maximum external cost such issuer would incur will be \$776 per year.<sup>528</sup> For an

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<sup>526</sup> Id.

<sup>527</sup> Id.

<sup>528</sup> See Proposing Release, supra note 2, 74 FR at 36857. The total maximum external cost for a Category 1 demand securities issuer is calculated as follows: [\$64 (cost to have third party convert annual filing into an electronic format) x 2 (maximum estimated number of annual filings filed per year per issuer)] + [\$8 (cost to have third party convert event notices or failure to file notices into an electronic format) x 6 (maximum estimated number of event or failure to file notices filed per year per issuer)] + [\$50 (estimated monthly Internet charge) x 12 months] = \$776. The Commission estimates that an issuer will file one to eight continuing disclosure documents per year. These documents generally will consist of no more than two annual filings and six event or failure to file

issuer that does not have Internet access and elects to acquire the technological resources to convert continuing disclosure documents into an electronic format internally ("Category 2"), the estimated total maximum external cost such demand securities issuer would incur will be \$4,900 for the first year and \$600 per year thereafter.<sup>529</sup> To provide a conservative estimate for PRA purposes, the Commission estimated that any demand securities issuers that incur costs associated with converting continuing disclosure documents into an electronic format will choose the Category 2 option.<sup>530</sup> The Commission estimated that approximately no more than 400 demand securities issuers will incur costs associated with acquiring technological resources to convert continuing disclosure documents into an electronic format.<sup>531</sup> The Commission included these estimates in the Proposing Release and received no comments on them. The Commission continues to believe they are appropriate.

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notices. The Commission estimates the maximum number of documents filed annually per issuer as follows: 7 documents (consisting of 2 annual filings and 5 event or failure to file notices) + 1 document (consisting of the additional event notice that would be filed under the amendments). In the Proposing Release, the Commission estimated that the maximum number of documents filed annually per issuer would be \$760. This estimate was based on 5 documents (consisting of 2 annual filings and 3 event or failure to file notices) + 1 document (consisting of the additional event notice that would be filed under the amendments). As discussed above, the Commission is updating this number to reflect more current data submitted to the MSRB. See supra note 368 and accompanying text. The above cost estimate is higher than the estimate in the Proposing Release by \$16 or 2.1%.

<sup>529</sup> See Proposing Release, supra note 2, 74 FR at 36857. The total maximum external cost for a Category 2 demand securities issuer is calculated as follows: [\$4300 (maximum estimated one-time cost to acquire technology to convert continuing disclosure documents into an electronic format)] + [\$50 (estimated monthly Internet charge) x 12 months] = \$4900. After the initial year, issuers who acquire the technology to convert continuing disclosure documents into an electronic format internally will have only the cost of obtaining Internet access. \$50 (estimated monthly Internet charge) x 12 months = \$600.

<sup>530</sup> See Proposing Release, supra note 2, 74 FR at 36857.

<sup>531</sup> 2,000 demand securities issuers x 20% = 400 demand securities issuers. The Commission used a 20% estimate in the Proposing Release. The Commission believes that this estimate is still appropriate.

In addition, the Commission estimates that the aggregate maximum annual costs for those demand securities issuers that need to acquire technological resources to submit documents to the MSRB will be approximately \$1,960,000<sup>532</sup> for the first year after the adoption of the amendments and approximately \$240,000<sup>533</sup> for each year thereafter. The Commission included these cost burden estimates in the Proposing Release and received no comments on them. The Commission continues to believe that these estimates are appropriate.

c. Current Issuers and Demand Securities Issuers

Some current issuers and demand securities issuers may incur a one-time external cost associated with the amendment to revise the time frame for submitting event notices from “in a timely manner” to “in a timely manner not to exceed ten business days after the occurrence of the event.” In particular, some current issuers and demand securities issuers may incur a one-time external cost associated with becoming apprised of the appointment of a new trustee or for the change in the trustee’s name. One way an issuer may become apprised of such a change would be for its counsel to add a notice provision to the issuer’s trust indenture that requires the trustee to provide the issuer with notice of the appointment of a new trustee or any change in the trustee’s name. Based on industry sources, the Commission estimates that it will take an outside attorney approximately 15 minutes to draft and add a provision to an indenture agreement requiring notice of a change of trustee or to the trustee’s name. Thus, the Commission estimates that the approximate cost of adding this notice provision to an issuer’s trust indenture will be approximately \$100 per issuer,<sup>534</sup> for a one-time annual cost of \$1,200,000<sup>535</sup> for all issuers. The

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<sup>532</sup> 400 (Category 2 issuers) x \$4,900 = \$1,960,000.

<sup>533</sup> 400 (Category 2 issuers) x \$600 = \$240,000.

<sup>534</sup> 1 (continuing disclosure agreement) x \$400 (hourly wage for an outside attorney) x .25 hours (estimated time for outside attorney to draft and add a change of name notice

Commission included these cost burden estimates in the Proposing Release and received no comments on them. The Commission continues to believe they are appropriate.

As discussed in the Proposing Release, the Commission solicited comment regarding the accuracy of its cost burden estimates in connection with the revised collection of information applicable to issuers. As noted above, although some commenters offered general comments relating to issuers' burdens and costs under the Rule, they did not quantify these burdens or costs. For example, some commenters expressed the view that the Commission underestimated the burdens or costs that would be imposed on issuers and obligated persons as a result of the amendments.<sup>536</sup> A number of commenters expressed concern about additional burdens or costs, which they believed issuers would incur as a result of the ten business day time frame for submitting notices for events outside of the issuer's control.<sup>537</sup> These commenters also remarked that these increased burdens or costs would be particularly difficult for small issuers.<sup>538</sup>

Although these commenters provided general views relating to issuers' burdens and costs under the Rule, which are addressed in Section V.D.2 above, they did not offer specific information or

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provision to a trust indenture) = \$100. The \$400 per hour estimate for an outside attorney's work is based on industry sources.

<sup>535</sup> \$100 (estimated cost to have outside counsel add a notice provision to a trust indenture) x 12,000 (number of issuers under the amendments) = \$1,200,000.

<sup>536</sup> See Connecticut Letter at 3 ("I suspect that the Commission has underestimated the true costs of some of these proposals"), NABL Letter at 12-13 ("The Commission's estimates of costs and other regulatory impacts . . . greatly underestimate the likely impact of the amendments"), and GFOA Letter at 5 ("The SEC's estimated time needed and costs associated with implementing the proposals are a fraction of what issuers will likely incur. This is true for both small and large issuers, as compliance costs and monitoring will increase, as will an issuer's need to retain bond counsel").

<sup>537</sup> See Halgren Letter at 1-2, Kutak Letter at 2, NAHEFFA Letter at 3, Los Angeles Letter at 2, San Diego Letter at 3, California Letter at 2-3, CHEFA Letter at 2-3, CRRC Letter at 5, WCRRC Letter at 1, and Connecticut Letter at 3. See supra Section V.D.2.i.a.c.

<sup>538</sup> Id.

data that conflicted with the Commission's cost estimates nor did they provide alternative estimates. As discussed above, the Commission agrees that some issuers, including small issuers, will have increased burdens and costs under the Rule. However, for the reasons discussed in Section V.D.2 above, the Commission continues to believe that these burdens and costs are accounted for in the Commission's PRA burden analysis.

In addition to the commenters discussed above, two commenters opposed the proposed amendment to modify the exemption for demand securities because they viewed it as imposing an audit requirement on small issuers.<sup>539</sup> One of these commenters stated that the proposal could increase costs to a small issuers by \$30,000-40,000 annually to prepare audited or consolidated financial statements.<sup>540</sup> The commenter believed that such costs could force small demand securities issuers to withdraw from the tax-exempt municipal market and thus recommended that the Commission withdraw the proposed amendment to modify the exemption for demand securities or create a limited exception for LOC-backed demand securities.<sup>541</sup>

As discussed further in Section III.A. above, the Commission notes that, for purposes of paragraph (b)(5)(i)(B) of the Rule, audited financial statements need to be submitted, pursuant to the issuer's and obligated person's undertaking in a continuing disclosure agreement, only "when and if available."<sup>542</sup> This limitation, which is consistent with the Commission's position in the 1994 Amendments Adopting Release, should mitigate some concerns of those obligated persons

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<sup>539</sup> See CRRC Letter at 5 and WCRR Letter at 1 (generally expressed support for comments in CRRC Letter).

<sup>540</sup> Id.

<sup>541</sup> Id.

<sup>542</sup> 17 CFR 240.15c2-12(b)(5)(i)(B). See also supra Section III.A. concerning audited financial statements and 1994 Amendments Adopting Release, supra note 8, 59 FR at 59599.

that do not prepare audited financial statements in the ordinary course of their business.<sup>543</sup>

Further, although not all issuers or obligated persons, in the ordinary course of their business, prepare audited financial statements or other financial and operating information of the type included in annual filings, a number of issuers and obligated persons do.<sup>544</sup>

The Commission acknowledges that issuers or obligated persons of demand obligations that assemble financial and operating data for the first time in response to their undertakings in a continuing disclosure agreement may incur incremental costs beyond those costs incurred by those issuers or obligated persons that already assemble this information.<sup>545</sup> Also, smaller issuers or obligated persons may have relatively greater burdens than larger issuers or obligated persons. However, the overall burdens for these demand securities issuers or obligated persons in preparing financial information are expected to be commensurate with those of issuers or obligated persons that already are preparing financial information as part of their continuing disclosure undertakings.<sup>546</sup> The Commission believes that the burdens that will be incurred in

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<sup>543</sup> As discussed in the 1994 Amendments Adopting Release, the 1994 Amendments “[do] not adopt the proposal to mandate audited financial statements on an annual basis with respect to each issuer and significant obligor. Instead, the amendments require annual financial information, which may be unaudited, and may, where appropriate and consistent with the presentation in the final official statement, be other than full financial statements. . . . However, if audited financial statements are prepared, then when and if available, such audited financial statements will be subject to the undertaking and must be submitted to the repositories. Thus . . . the undertaking must include audited financial statements only in those cases where they otherwise are prepared.” See 1994 Amendments Adopting Release, supra note 8, 59 FR at 59599.

<sup>544</sup> See <http://www.emma.msrb.org> for audited financial statements or other financial and operating information submitted to EMMA.

<sup>545</sup> The Commission, however, believes that the operations of an issuer or obligated person generally entail the preparation and maintenance of at least some financial and operating data.

<sup>546</sup> Further, issuers or obligated persons that assemble financial and operating data for the first time may face a greater burden than those issuers or obligated persons that already assemble this information. The amendments therefore initially may have a disparate

the aggregate by issuers or obligated persons, as a result of the amendments with respect to demand securities, may not be significant and, in any event, are justified by the benefits to investors of enhanced disclosure.<sup>547</sup>

As indicated above, another commenter stated its view that the proposed amendments would increase an issuer's need to retain bond counsel.<sup>548</sup> To the extent that bond counsel will need to be retained to revise the continuing disclosure agreement or add a notice provision to the issuer's trust indenture, the Commission has provided estimates relating to these costs in Section V.E.2, above.

F. Retention Period of Recordkeeping Requirements

The amendments do not contain any recordkeeping requirements. However, as a self-regulatory organization subject to Rule 17a-1 under the Exchange Act,<sup>549</sup> the MSRB is required to retain records of the collection of information for a period of not less than five years, the first two years in an easily accessible place. The amendments to the Rule contain no recordkeeping requirements for any other persons.

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impact on those issuers or obligated persons, including small entities, entering into a continuing disclosure agreement for the first time, as compared with those that already have outstanding continuing disclosure agreements.

<sup>547</sup> See supra Section V.D. As discussed therein, some commenters believed that the amendment could force some small entities to withdraw from the tax-exempt market because: (1) disclosure of small issuers' or obligated persons' financial information would provide their large, national competitors with information about these small issuers or obligated persons, which they believed could result in a competitive disadvantage to them; and (2) small issuers or obligated persons would have to prepare costly audited financial statements. See, e.g., CRRC Letter at 3-4 and WCRRC Letter at 1. As discussed above, the undertakings contemplated by the amendments (and Rule 15c2-12 in general) require annual financial information only to the extent provided in the final official statement, and audited financial statements only when and if available.

<sup>548</sup> See GFOA Letter at 5.

<sup>549</sup> 17 CFR 240.17a-1.

G. Collection of Information is Mandatory

The collection of information is mandatory.

H. Responses to Collection of Information Will Not Be Kept Confidential

The collection of information will not be confidential and will be publicly available. The collection of information will be accessible through the MSRB's EMMA system and thus will be publicly available via the Internet.

VI. Costs and Benefits of Amendments to Rule 15c2-12

A. Background

Rule 15c2-12 is intended to enhance disclosure and deter fraud in the municipal securities market by establishing standards for obtaining, receiving and disseminating information about municipal securities by their underwriters.<sup>550</sup> The amendments to Rule 15c2-12 revise certain requirements regarding the information that a Participating Underwriter must reasonably determine that an issuer of municipal securities or an obligated person has undertaken, in a written agreement or contract for the benefit of holders of the issuer's municipal securities, to provide to the MSRB. Specifically, the amendments: (1) narrow a previously-existing exemption from the Rule for demand securities, subject to the limited grandfather provision; (2) specify that the time period as to which the Commission's rules require a Participating Underwriter to reasonably determine that the issuer or obligated person has agreed to provide notice of specified events in a timely manner must not be in excess of ten business days after the event's occurrence; (3) eliminate materiality qualifications for certain events triggering a notice to the MSRB; and (4) add additional events to the list of events for which a notice is provided.

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<sup>550</sup> See 1989 Adopting Release, 1994 Amendments Adopting Release, and 2008 Amendments Adopting Release, supra note 8.



The Commission is deleting the exemption for demand securities set forth in paragraph (d)(1)(iii) of the Rule and adding new paragraph (d)(5) to the Rule, thereby making the continuing disclosure provisions of paragraphs (b)(5) and (c) of the Rule apply to a primary offering of demand securities,<sup>551</sup> subject to the limited grandfather provision described below. This change applies to any primary offering of demand securities (including a remarketing that is a primary offering) occurring on or after the compliance date of the final amendments.<sup>552</sup> The Commission's amendment differs from the amendment the Commission originally proposed in that it includes a "limited grandfather provision" for remarketings of currently outstanding demand securities. Specifically, the continuing disclosure provisions will not apply to remarketings of demand securities that are outstanding in the form of demand securities on the day preceding the compliance date of the final amendments and that continuously have remained outstanding in the form of demand securities. This amendment will increase the amount of information in the market relating to primary offerings of demand securities occurring on or after the compliance date and will provide investors with valuable information, thereby enabling them to make better informed investment decisions relating to whether they should buy, sell, or hold such securities and reduce the likelihood that investors will be subject to fraud facilitated by inadequate disclosure.

The amendment to the Rule regarding notice of specified events "in a timely manner not in excess of ten business days" after the event's occurrence will have the effect of establishing a definitive time frame for the submission of event notices. This provision will supplement the "in a timely manner" language that existed in the Rule prior to these amendments, which allowed for

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<sup>551</sup> See supra note 38 and accompanying text.

<sup>552</sup> As noted in Section III.G., the compliance date for the amendments to the Rule is December 1, 2010.

the possibility of event notices being submitted to the MSRB at inconsistent times for similar events, because each issuer could decide for itself what constitutes “in a timely manner.”

Because the Rule did not contain a specific time frame for submission of event notices, investors could not be certain whether or not an event had occurred over an indefinite period in the past.

This amendment still requires Participating Underwriters to reasonably determine that a continuing disclosure agreement provides for timely disclosure, but sets an outside time frame of ten business days after the event’s occurrence for submission of an event notice. To the extent that issuers provide disclosure within ten business days, consistent with their continuing disclosure agreements, there likely will be more certainty for investors concerning when they will receive information concerning such events and, on the whole, more timely information to investors and the municipal securities market generally. More up-to-date information about municipal securities can serve to protect investors from fraud facilitated by inadequate disclosure and assist investors in determining whether the price of a municipal security is appropriate.

The amendment to remove the “materiality” condition for six specified events in paragraph (b)(5)(i)(C) of the Rule will have the effect of increasing the disclosure of such events to investors and the municipal securities market generally.<sup>553</sup> In addition, issuers and obligated persons no longer will have to separately analyze whether each occurrence of such events is material.

In addition, the amendment to modify paragraph (b)(5)(i)(C)(6) of the Rule, which relates to a Participating Underwriter’s obligation to reasonably determine that the issuer or obligated person has undertaken in a continuing disclosure agreement to provide notice to the MSRB of

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<sup>553</sup> These events are: (1) principal and interest payment delinquencies; (2) unscheduled draws on debt service reserves reflecting financial difficulties; (3) unscheduled draws on credit enhancements reflecting financial difficulties; (4) substitution of credit or liquidity providers, or their failure to perform; (5) defeasances; and (6) rating changes.

certain tax events, will have the effect of enhancing the disclosure of events that are important to investors in determining whether the tax status of their municipal securities is at risk.

The amendment to modify paragraph (b)(5)(i)(C) of the Rule adds four new event items to be disclosed to investors.<sup>554</sup> The disclosure of these events will provide investors and the market with important information regarding municipal securities.

These amendments are intended to help improve the availability of timely and important information to investors and other market participants regarding municipal securities, including demand securities, so that investors can make more knowledgeable investment decisions, effectively manage and monitor their investments, and help reduce the likelihood of fraud facilitated by inadequate disclosure. In addition, the amendments are intended to help brokers, dealers, and municipal securities dealers to satisfy their obligation to have a reasonable basis on which to recommend a municipal security.

The Commission is sensitive to the costs and benefits that result from its rules. In the Proposing Release, the Commission identified certain costs and benefits of the amendments as proposed and requested comment on all aspects of its cost-benefit analysis, including the identification and assessment of any cost and benefits not discussed in the analysis. The Commission sought comment on the value of the benefits identified and the accuracy of its cost estimates. The Commission also encouraged commenters to provide relevant data. The Commission received some comments relating to the Commission's cost-benefit analysis. For

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<sup>554</sup> These events are: (1) tender offers; (2) bankruptcy, insolvency, receivership or similar event of the obligated person; (3) consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to such actions, other than pursuant to its terms, if material; and (4) appointment of a successor or additional trustee, or the change of name of a trustee, if material.

the reasons discussed below, the Commission continues to believe that its estimates of the benefits and costs of the amendments to the Rule 15c2-12, as set forth in the Proposing Release, are appropriate.

B. Benefits

The Commission discusses below the benefits of the Rule for each amendment to the Rule.

1. Increased Disclosure Relating to Demand Securities

The Commission is modifying the Rule's exemption for primary offerings of demand securities (including any remarketing that is a primary offering) to narrow the Rule's prior exemption, which will result in the greater availability of information about these securities to investors, broker-dealers, municipal securities analysts, and the securities markets generally. In addition, under this amendment, a broker, dealer or municipal securities dealer that recommends the purchase or sale of demand securities will need to have procedures in place that provide reasonable assurance that it will receive prompt notice of event notices and failure to file notices.<sup>555</sup>

The greater availability of information regarding demand securities should increase the efficiency of markets in allocating capital at appropriate prices that reflect the creditworthiness of issuers and increase the efficiency of prices in the secondary market, benefiting issuers and investors alike, and should also benefit investors by allowing them to make more informed decisions whether to buy, sell or hold these securities. This greater availability of information is also likely to benefit brokers, dealers, or municipal securities dealers by reducing their costs in forming a reasonable basis for recommending demand securities. Specifically, these market

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<sup>555</sup> Sec 17 CFR 240.15c2-12(c).

participants will have more information about these securities to draw upon when they are deciding whether or not to recommend demand securities to investors. Greater availability of information also will benefit broker-dealers and municipal securities dealers by reducing their costs in establishing secondary market quotations for demand securities. In addition, greater transparency in the market due to the applicability of the continuing disclosure requirements to demand securities should reduce the likelihood that investors will be subject to fraud facilitated by inadequate disclosure, resulting in potentially reduced costs associated with such fraud.

By 2009, the outstanding amount of VRDOs was estimated to be approximately \$400 billion, which is a significant percentage of the municipal securities market.<sup>556</sup> The Commission recognizes that some issuers of demand securities voluntarily provide continuing disclosure documents, notwithstanding the exemption for demand securities that existed prior to the amendments. Therefore, the above-referenced benefits will result primarily from the additional disclosure that is provided by issuers of demand securities that did not previously provide continuing disclosure documents.

A number of commenters were supportive of applying the continuing disclosure to demand securities.<sup>557</sup> Several commenters agreed that the amendments relating to demand securities are critical to assist investors in making informed investment decisions.<sup>558</sup> One commenter noted that the market for demand securities was among the sectors most affected by the recent market turmoil and, consequently, stated its view that there is "little justification for

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<sup>556</sup> See Andrew Ackerman, "Concerns Raised on VRDOs," *The Bond Buyer*, June 9, 2009.

<sup>557</sup> See California Letter at 1, CHEFA Letter at 2, Connecticut Letter at 1, DAC Letter at 3, e-certus Letter I at 11, Fidelity Letter at 3, Folts Letter at 1, ICI Letter at 2, NFMA Letter at 1, RBDA Letter at 2, and SIFMA Letter at 2.

<sup>558</sup> See, e.g., ICI Letter at 5, SIFMA Letter at 2, and RBDA Letter at 2.

exempting VRDOs from continuing disclosure requirements.”<sup>559</sup> Similarly, another commenter stated that, during the recent market downturn, investors in demand securities were well served by those issuers or obligated persons who voluntarily provided continuing disclosures about these securities, despite the Rule’s exemption.<sup>560</sup> Another commenter believed that, because many VRDO issuers already are subject to requirements for continuing disclosure and the submission of material event notices for their fixed rate debt, the submission of information with respect to their VRDOs will not be a significant burden and will provide access to information about these securities to a much broader segment of the market.<sup>561</sup>

## 2. More Timely Disclosure

Establishing an outside time frame of ten business days after the occurrence of the specified event to submit an event notice will help improve the timeliness of the dissemination of the information to investors and the market. The more timely availability of event notices will help improve the efficient pricing of municipal securities and will benefit investors by allowing them to make more informed investment decisions and to do so with greater certainty as to the timeliness of available information. The more timely availability of event notices also will contribute to the speedier dissemination of event notices to the market, which may, in turn, trigger important contractual rights that may have otherwise been delayed. In addition, the increased availability of up-to-date information about municipal securities is likely to improve the transparency in the market; should increase the efficiency of markets in allocating capital at appropriate prices that reflect the creditworthiness of issuers, which benefits issuers and

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<sup>559</sup> See RBDA Letter at 2.

<sup>560</sup> See CHEFA Letter at 2.

<sup>561</sup> See NMFA Letter at 1.

investors alike; and should reduce the likelihood that investors will be subject to fraud facilitated by inadequate disclosure.

Four commenters supported the proposal to establish a ten business day time frame for the submission of event notices pursuant to a continuing disclosure agreement.<sup>562</sup> Two of these commenters indicated that the benefits of the proposed amendment include more timely and efficient access to comprehensive and accurate information about municipal securities, which is critical to investors.<sup>563</sup> These commenters also noted that the establishment of a definitive time frame by which event notices are to be submitted better informs the market that an event has occurred, which assists in the efficient pricing of their municipal securities.<sup>564</sup> Two commenters also noted that the definitive time frame provides more timely information to pricing evaluation services and relieves investors of dependence on bondholders to disclose information to these services.<sup>565</sup>

3. Increased Disclosure Due to the Deletion of the Materiality Condition for Six Events

The Commission is adopting the proposal to delete the “if material” condition with respect to notice for six of the Rule’s disclosure events.<sup>566</sup> The deletion of the materiality condition for these six events will benefit issuers by eliminating the costs presently incurred by an issuer in making such a determination. Further, because issuers will not need to make a materiality determination, this Rule revision is likely to help speed the disclosure of these six events to investors and other market participants and help improve the efficient pricing of

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<sup>562</sup> See NFMA Letter at 1-2, SIFMA Letter at 3, ICI Letter at 6-7, and Fidelity Letter at 3-4.

<sup>563</sup> See ICI Letter at 1 and Fidelity at 2.

<sup>564</sup> Id.

<sup>565</sup> Id.

<sup>566</sup> See supra note 553 describing the events.

municipal securities. Greater certainty that information about these events will be disclosed pursuant to continuing disclosure agreements also is likely to help improve the transparency of the municipal security's pricing. The greater availability of information regarding events that have an immediate effect on the valuation of the security will help reduce the likelihood of fraud facilitated by inadequate disclosure, and in return will help reduce costs associated with such fraud.

A number of commenters supported the deletion of the "if material" qualification for these six events and believed that this change would be beneficial.<sup>567</sup> For example, one commenter believed that notice of these events should always be provided because their occurrence is always important to investors and other market participants. The commenter also noted that, in all probability, the amendment will not result in many changes to current practice.<sup>568</sup> Two other commenters also agreed that these events are important to investors, and generally should be known immediately to issuers.<sup>569</sup> Another two commenters concurred that many disclosure events are of such high consequence and relevance to investors in informing their investment decisions that they should be disclosed as a matter of course.<sup>570</sup> These commenters also supported the unqualified disclosure of two events, *i.e.*, bond calls and non-payment related defaults, for which a materiality condition is retained.<sup>571</sup>

#### 4. Increased Disclosure of Tax-Related Events

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<sup>567</sup> See California Letter at 2, San Diego Letter at 2, SIFMA Letter at 3, ICI Letter at 7-8, and Fidelity Letter at 3.

<sup>568</sup> See SIFMA Letter at 3.

<sup>569</sup> See California Letter at 2 and San Diego Letter at 2.

<sup>570</sup> See ICI Letter at 7-8 and Fidelity Letter at 3.

<sup>571</sup> Id.



The amendments also require a Participating Underwriter to reasonably determine that the issuer or obligated person has undertaken in a continuing disclosure agreement to provide notice to the MSRB of adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security. The improved disclosure of the tax status of municipal securities will benefit investors by helping to ensure that the information about the tax status of the municipal security is reflected in the price of the security in a timely manner.

Two commenters agreed that the amendment will benefit investors and the market. One commenter stated that the tax status of tax-exempt debt is of critical concern to many municipal investors, particularly municipal mutual funds, and that an adverse tax opinion likely will substantially decrease the market value and liquidity of a security.<sup>572</sup> Thus, the subsequent sale of the affected security could have a significant financial impact on investors.<sup>573</sup> A second commenter believed that investors have a strong interest in being informed of actions taken by the IRS that present a material risk to the tax-exempt status of their holdings.<sup>574</sup>

##### 5. Increased Disclosure of Additional Events

The amendments also add four new event items to Rule 15c2-12. The amendments add the disclosure of tender offers to the provision of the Rule that currently applies only to bond calls.<sup>575</sup> Information regarding a tender offer, which necessitates that an investor decide whether or not to tender within the prescribed time period, will improve the ability of issuers and other

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<sup>572</sup> See NFMA Letter at 2.

<sup>573</sup> Id.

<sup>574</sup> See SIFMA Letter at 3.

<sup>575</sup> See supra Section III.E.1.

obligated persons to communicate tender offers to bondholders effectively and of bondholders to respond within the tender offer period. In addition, the amendment should help reduce the possibility of investor confusion regarding whether a certain municipal security is the subject of a tender offer.

The amendments also add the disclosure of bankruptcy, insolvency, receivership or similar event of the obligated person.<sup>576</sup> While these events are uncommon in the municipal market, their improved disclosure can have a significant effect on the price of the municipal securities.

In addition, the amendments add the disclosure of the consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material.<sup>577</sup> As with bankruptcy, insolvency, receivership or similar event of the obligated person, the improved disclosure of the consummation of a material merger, consolidation, or acquisition or the sale of all or substantially all of the assets of the obligated person can have a significant effect on the price of the municipal securities. This amendment is likely to help improve investors' and other market participants' ability to obtain knowledge of the identity of the entity that will have responsibility for municipal security repayment obligations after the transaction is consummated. In addition, investors and other market participants will have the opportunity to review the creditworthiness and other aspects of the acquiring entity that support repayment of the security following the transaction.

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<sup>576</sup> See supra Section III.E.2.

<sup>577</sup> See supra Section III.E.3.

The addition of these new disclosure events to the Rule will help improve the informativeness of the municipal security prices with respect to these events, which will benefit investors, issuers, broker-dealers, municipal securities analysts and other market participants. In addition, greater transparency should reduce the likelihood of fraud facilitated by inadequate disclosure, and in return will help reduce costs associated with such fraud.

Under the amendments, the appointment of a successor or additional trustee or the change of name of a trustee, if material, is added to the list of events contained in the Rule. As discussed earlier, the trustee of a municipal security performs important functions for investors in that security, including providing information to bondholders.<sup>578</sup> This amendment is likely to benefit investors by helping reduce the costs associated with determining the identity of and contact information for the most current trustee and that of any new trustee.

Several commenters supported the addition of the new event items to the Rule.<sup>579</sup> For example, two commenters believed that disclosure of trustee-related events will provide meaningful insights and information regarding a particular bond.<sup>580</sup> One of these commenters particularly noted that it was critical that investors are informed of trustee name changes since bondholders' rights are generally exercised through the actions of the trustee.<sup>581</sup> Another commenter noted that disclosure of trustee-related events will likely always be of importance to both retail and institutional investors.<sup>582</sup>

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<sup>578</sup> See supra Section III.E.4.

<sup>579</sup> See ICI Letter at 8, Fidelity Letter at 2-3, Connecticut Letter at 2, NFMA Letter at 2, and SIFMA Letter at 4.

<sup>580</sup> See ICI Letter at 8 and Fidelity Letter at 2.

<sup>581</sup> See Fidelity Letter at 3.

<sup>582</sup> See NFMA Letter at 2.

B. Costs

The Commission discusses below the costs of the amendments to the Rule for various market participants.

1. Broker-Dealers

Broker-dealers are not likely to incur significant additional recurring external or internal costs in connection with the implementation of the Rule, as amended, because the amendments will not significantly alter the Rule's existing requirements for broker-dealers. As discussed above, broker-dealers acting as Participating Underwriters have an existing obligation to reasonably determine that issuers or obligated persons have undertaken in their continuing disclosure agreements to provide notice to the MSRB of specified events. The Commission does not expect that the addition of several new disclosure events to the Rule and a provision establishing the time frame for submission of such notices are likely to significantly alter broker-dealers' obligations under the Rule and thus their costs. As a practical matter, broker-dealers' obligations affected by the amendments involve verifying that the continuing disclosure agreement contains an undertaking by the issuer or obligated person to provide notice to the MSRB of the events that are listed in the Rule, including the new events, within ten business days after the event's occurrence. Moreover, because continuing disclosure documents generally are form documents, a broker-dealer simply will need to make sure that the continuing disclosure agreement reflects the amendments to the Rule.

The amendments also modify the Rule's exemption for demand securities. This change applies to any initial offering and remarketing that is a primary offering of demand securities occurring on or after the compliance date of the amendments and does not apply to remarketings of demand securities that are outstanding in the form of demand securities on the day preceding

the compliance date and that continuously have remained outstanding in the form of demand securities (i.e., the limited grandfather provision).

Although the amendments relating to demand securities are not likely to result in external recurring costs for broker-dealers, broker-dealers may incur an increase in internal recurring costs because the proposals will increase the number of municipal securities offerings subject to the Rule's disclosure requirements. As noted above, the Commission estimates that the modification of the exemption for demand securities will increase the number of issuers with municipal securities offerings subject to the Rule by 20%.<sup>583</sup> The Commission estimates that the annual information collection burden for each broker-dealer under this amendment will be 1.20 hours (1 hour and 12 minutes).<sup>584</sup> Accordingly, the Commission estimates that it will cost each broker-dealer \$349 annually to comply with the Rule, which represents a cost increase of \$79 annually over each broker-dealer's current annual cost.<sup>585</sup>

In addition, the Commission estimates that a broker-dealer may have a one-time internal cost associated with having an in-house compliance attorney prepare and issue a memorandum

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<sup>583</sup> See supra Section V.D.2.a. As noted above, adoption of the limited grandfather provision will not materially affect the Commission's estimate of the number of demand securities issuers that will be affected by the amendments. Therefore, the Commission is retaining its estimate that there will be a 20% increase in the number of issuers affected by the amended Rule.

<sup>584</sup> Id.

<sup>585</sup> 1.20 hours (estimated annual information collection burden for each broker-dealer) x \$291 (hourly cost for a broker-dealer's internal compliance attorney) = \$349. The hourly rate for the compliance attorney is from SIFMA's Management & Professional Earnings in the Securities Industry 2009, modified by the Commission's staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. Cost increase for Broker-Dealers under the amendments: \$349 (annual cost under amendments) - \$270 (previous annual cost) = \$79. This estimated cost for broker-dealers also accounts for their review of continuing disclosure agreements in connection with remarketings of demand securities that are primary offerings. The Commission has slightly revised this cost estimate upward from the estimate contained in the Proposing Release to reflect updated hourly rate information from SIFMA for 2009.

advising the broker-dealer's employees about the final revisions to Rule 15c2-12. The Commission estimates that it will take internal counsel approximately 30 minutes to prepare this memorandum,<sup>586</sup> for a cost of approximately \$146.<sup>587</sup> The Commission further believes that the ongoing obligations of broker-dealers under the Rule will be handled internally because compliance with these obligations is consistent with the type of work that a broker-dealer typically handles in-house.

The Commission included these specific cost estimates in the Proposing Release and received no comments on them.<sup>588</sup>

2. Issuers

a. Current Issuers

Some current issuers are likely to be subject to some internal and external costs associated with the amendments. The costs for current issuers will result from the amendments relating to the new and modified event notice provisions and the elimination of the materiality determination for certain of the Rule's events.<sup>589</sup> Current issuers will incur internal costs

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<sup>586</sup> See supra Section V.D.1.c.

<sup>587</sup> .5 hours (estimated annual information collection burden for each broker-dealer) x \$291 (hourly cost for a broker-dealer's internal compliance attorney) = \$146. The hourly rate for the compliance attorney is from SIFMA's Management & Professional Earnings in the Securities Industry 2009, modified by the Commission's staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. The Commission has slightly revised this cost estimate upward from the estimate contained in the Proposing Release to reflect updated hourly rate information from SIFMA for 2009.

<sup>588</sup> These cost estimates correspond with the burden estimates set forth in Section V.D.1., above. Therefore, to the extent the Commission received comments that generally relate to broker-dealers' costs under the Rule, they are discussed above, and the responses to those comments are incorporated herein by reference. The Commission does not believe that these comments affect these cost estimates.

<sup>589</sup> The amendments include a materiality condition for two of the new disclosure events. A materiality determination may result in costs to investors, market professionals and others

associated with the preparation of the additional event notices that may result from these changes to the Rule. Current issuers also will incur costs if they issue demand obligations, as discussed in the next sub-section. As noted above, the revisions to the Rule regarding the ten business day time frame for submission of event notices and the elimination of the materiality condition for many of the Rule's disclosure events will not change the substance of an event notice, the method for filing an event notice, or the location to which an event notice will be submitted. Consequently, issuers may not incur costs associated with the new ten business day time frame for submission of event notices. As discussed above, some issuers, including small issuers, may need to submit event notices more promptly than they do now and may need to monitor events not within their direct control, such as a rating change, that will prompt submission of an event notice.

The Commission also believes that current issuers may incur some internal labor costs associated with the preparation and submission of additional event notices. As discussed above,<sup>590</sup> the Commission estimates that a current issuer will submit a maximum of one additional event notice annually.<sup>591</sup> Thus, the Commission estimates that the maximum annual labor cost to prepare and submit the additional event notice is approximately \$44 per current issuer.<sup>592</sup>

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to the extent that the issuer or obligated person determines that the event is not material and thus does not submit a notice to the MSRB. If investors, market professionals and others would consider the information important and have access to it, they may reach a different investment decision.

<sup>590</sup> See supra Section V.E.2.a.

<sup>591</sup> This estimate includes additional event notices that may be submitted as a result of the modification of the materiality condition in paragraph (b)(5)(i)(C) of the Rule.

<sup>592</sup> 1 (maximum estimated number of additional material event notices submitted per year per issuer) x \$59 (hourly wage for a compliance clerk) x .75 hours (45 minutes) (estimated time for compliance clerk to prepare and submit a material event notice) =

For current issuers that convert their annual filings, event notices and/or failure to file notices into the MSRB's prescribed electronic format through a third party, there will be costs associated with any additional submissions of event notices and failure to file notices. As noted above, the Commission estimates that each current issuer will submit one additional event notice annually as a result of the amendments.<sup>593</sup> If a current issuer uses a third-party vendor to scan the additional event notice into an electronic format for submission to the MSRB, the Commission estimates that such issuer will have an additional annual cost of \$8 per notice.<sup>594</sup> For current issuers that convert their annual filings, event notices and/or failure to file notices into the MSRB's prescribed electronic format internally there will be no additional external costs associated with such conversion. Further, some current issuers may incur a one-time cost of \$100 associated with a revision to the template for continuing disclosure agreements.<sup>595</sup>

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\$44.25 (rounded to \$44). The \$59 per hour estimate for a compliance clerk is from SIFMA's Office Salaries in the Securities Industry 2009, modified by the Commission's staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead. The Commission has slightly revised this cost estimate downward from the estimate contained in the Proposing Release to reflect updated hourly rate information from SIFMA for 2009. To provide an estimate of total costs for issuers that will not be under-inclusive, the Commission elected to use the higher end of the estimate of annual submissions of continuing disclosure documents.

<sup>593</sup> See supra Section V.E.2.a. These cost estimates correspond with the burden estimates set forth in Section V.D.2., above. Therefore, to the extent the Commission received comments that generally relate to issuers' costs under the Rule, they are discussed above, and the responses to those comments are incorporated herein by reference. The Commission does not believe that these comments affect these cost estimates.

<sup>594</sup> Id.

<sup>595</sup> Id. The Commission estimates that there is an approximate cost of \$100 associated with revising the issuer's continuing disclosure agreement by the current issuer's outside counsel to conform the agreement to the amendments. Thus, the total cost for revising continuing disclosure agreements for all current issuers by the current issuers' outside counsel will be approximately \$1,000,000.



The Commission included these specific cost estimates in the Proposing Release and received no comments on them.<sup>596</sup>

b. Demand Securities Issuers

As discussed above, the Commission estimates that the modification of the Rule's exemption for demand securities will increase the number of issuers affected by the Rule by approximately 20% or 2,000 issuers.<sup>597</sup> These demand securities issuers are likely to have some costs associated with the preparation and submission of continuing disclosure documents. Also as discussed in the PRA section above, the Commission estimates that each demand securities issuer may have a one-time external cost of \$600 associated with preparing into a continuing disclosure agreement.<sup>598</sup>

Other external costs for demand securities issuers are likely to be the costs associated with converting continuing disclosure documents into an electronic format to submit to the MSRB. As noted in the PRA section above, the Commission believes that many issuers of municipal securities currently have the computer equipment and software necessary to convert paper copies of continuing disclosure documents to electronic copies and to electronically transmit the documents to the MSRB.<sup>599</sup> Demand securities issuers that presently do not have the ability to prepare their annual filings, event notices and/or failure to file notices in an

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<sup>596</sup> The Commission has slightly revised these cost estimates upward from the estimates contained in the Proposing Release to reflect updated hourly rate information from SIFMA for 2009.

<sup>597</sup> See supra Section V.C.

<sup>598</sup> See supra Section V.E.2.b. The Commission estimated that there is an approximate cost of \$600 associated with drafting a continuing disclosure agreement by the demand securities issuer's outside counsel. Thus, the total cost for preparing continuing disclosure documents for all demand securities issuers by the demand securities issuers' outside counsel will be approximately \$1,200,000.

<sup>599</sup> Id.

electronic format may incur some costs to obtain electronic copies of such documents if they are prepared by a third party (e.g., accountant or attorney) or, alternatively, to have a paper copy converted into an electronic format. These costs will vary depending on how the demand securities issuer elects to convert its continuing disclosure documents into an electronic format. An issuer may elect to have a third-party vendor transfer its paper continuing disclosure documents into the appropriate electronic format. An issuer also may decide to undertake the work internally, and its costs will vary depending on the issuer's current technological resources. An issuer also may use the services of a designated agent to submit its continuing disclosure documents to the MSRB. In the Proposing Release, the Commission noted that approximately 30% of municipal issuers rely on the services of a designated agent to submit continuing disclosure documents for them.<sup>600</sup> Generally, when issuers utilize the services of a designated agent, they enter into a contract with the agent for a package of services, including the submission of continuing disclosure documents, for a single fee. The Commission estimates that the annual fees for designated agents range from \$100 to \$500 per issuer, for a total maximum annual cost of \$300,000 for all demand securities issuers.<sup>601</sup>

The Commission estimates that some demand securities issuers may have to convert continuing disclosure documents into an electronic format to submit to the MSRB. The costs associated with this conversion may include: (i) approximately \$8 per notice to use a third-party vendor to scan a event notice or failure to file notice, and approximately \$64 to use a third-party vendor to scan an average-sized annual financial statement; (ii) approximately \$750 to \$4,300 to acquire technological resources to convert continuing disclosure documents into an electronic format; (iii) approximately \$50 to \$300 solely to upgrade or acquire the software to submit

<sup>600</sup> See Proposing Release, supra note 2, 74 FR at 36862.

<sup>601</sup> See supra Section V.E.2.b.

documents in an electronic format; and (iv) approximately \$50 per month to establish Internet access.<sup>602</sup>

Based on the PRA section above, the Commission estimates that Category 1 demand securities issuers will incur a total maximum external cost of \$776 per year.<sup>603</sup> The Commission estimates that Category 2 demand securities issuers will incur a total maximum external cost of \$4,900 for the first year and \$600 per year thereafter.<sup>604</sup> As noted above, the Commission estimates that any demand securities issuer that incurs costs associated with converting continuing disclosure documents into the MSRB's prescribed electronic format will choose the more expensive Category 2 option.<sup>605</sup> The Commission estimates that approximately 400 demand securities issuers will incur costs associated with acquiring technological resources to convert continuing disclosure documents into an electronic format.<sup>606</sup> In addition, the Commission estimates that the maximum annual costs for those demand securities issuers that need to acquire technological resources to submit documents to the MSRB will be approximately \$1,960,000 for the first year after the adoption of the amendments and approximately \$240,000 for each year thereafter.<sup>607</sup>

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<sup>602</sup> Id.

<sup>603</sup> A Category 1 demand securities issuer is one that does not have Internet access and needs to have a third party convert continuing disclosure documents into an electronic format. See supra Section V.E.2.b.

<sup>604</sup> A Category 2 demand securities issuer is one that does not have Internet access and elects to acquire the technological resources to convert continuing disclosure documents into an electronic internally. See supra Section V.E.2.b.

<sup>605</sup> Id.

<sup>606</sup> 2,000 demand securities issuers x 20% = 400 demand securities issuers.

<sup>607</sup> See supra Section V.E.2.b.

The Commission included these specific cost estimates in the Proposing Release and received no comments on them.<sup>608</sup>

c. Current Issuers and Demand Securities Issuers

Lastly, as discussed in the PRA section above, some current issuers and some demand securities issuers are likely to incur external costs associated with the amendment to revise the timing for submitting event notices from “in a timely manner” to “in a timely manner not to exceed ten business days after the occurrence of the event.”<sup>609</sup> In particular, some current issuers and some demand securities issuers may incur external costs associated with monitoring the appointment of a new trustee or a change in the trustee’s name. One way an issuer may monitor such a change would be for its counsel to add a notice provision to the issuer’s trust indenture that requires the trustee to provide the issuer with notice of the appointment of a new trustee or any change in the trustee’s name. The Commission estimates that the approximate cost of adding this notice provision to an issuer’s trust indenture will be approximately \$100 per issuer,<sup>610</sup> for a one-time annual cost of \$1,200,000<sup>611</sup> for all issuers. The Commission included these specific cost estimates in the Proposing Release and received no comments on them.<sup>612</sup>

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<sup>608</sup> These cost estimates correspond with the burden estimates set forth in supra Section V.D.2. Therefore, to the extent the Commission received comments that generally relate to issuers’ costs under the Rule, they are discussed above, and the responses to those comments are incorporated herein by reference. The Commission does not believe that these comments affect these cost estimates.

<sup>609</sup> See supra Section V.E.2.c.

<sup>610</sup> Id.

<sup>611</sup> Id.

<sup>612</sup> Id. These cost estimates correspond with the burden estimates set forth in supra Section V.D.2. Therefore, to the extent the Commission received comments that generally relate to issuers’ costs under the Rule, they are discussed above, and the responses to those comments are incorporated herein by reference. The Commission does not believe that these comments affect these cost estimates.

In addition to the burdens and costs discussed in the PRA section above, the Commission received several comments relating to other costs and burdens associated with the proposed amendments. Several commenters expressed general concerns about the burdens and costs associated with the establishment of a maximum ten business day time frame for the submission of event notices. Some of these concerns included the impracticability of meeting the time frame because of limited staff and resources, especially for smaller issuers,<sup>613</sup> and the increased burdens and costs in connection with the additional monitoring and compliance necessary to submit notices within ten business days.<sup>614</sup> Other commenters expressed concerns relating to the submission of event notices for information that the issuer does not control (e.g., rating changes, changes to the trustee, and changes to the tax status of bonds as a result of an IRS audit) within the ten business day time frame.<sup>615</sup> In particular, many of these commenters expressed concerns regarding the costs associated with the reporting of rating changes within the ten business day time frame. These commenters noted that rating changes are not within the issuer's control and that rating organizations do not directly notify issuers of rating changes.<sup>616</sup> As a result, these commenters believed that it would be difficult for most issuers to meet the proposed ten business day time frame without incurring substantial costs associated with monitoring for rating changes,<sup>617</sup> such as devoting more staff to the task of monitoring for rating changes and/or subscribing to a service that will provide issuers notice of rating changes.

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<sup>613</sup> See CRRC Letter, WCRRC Letter, Portland Letter at 2, NAHEFFA Letter at 2-4, Metro Water Letter at 1-2, CHEFA Letter at 2, and NABL Letter at 5-6.

<sup>614</sup> See Halgren Letter, Los Angeles Letter at 1, CRRC Letter, WCRRC Letter, NAHEFFA Letter at 2-4, CHEFA Letter at 2, and NABL Letter at 5-6.

<sup>615</sup> See Halgren Letter, Los Angeles Letter at 1-2, NAHEFFA Letter at 2-4, San Diego Letter at 1-2, California Letter at 1-2, NABL Letter at 8, and GFOA Letter at 3-4.

<sup>616</sup> Id.

<sup>617</sup> See, e.g., Halgren Letter at 1.

The foregoing comments chiefly relate to concerns regarding submission of notices for events outside of the issuer's control. In this regard, the Rule currently contains a disclosure event relating to rating changes and so the concerns raised by these commenters are inherent in the Rule as it existed prior to the amendments, except that the amendments provide for event notices to be submitted within ten business days of the event's occurrence. In addition, for some event items, including rating changes, a materiality condition no longer will be a part of the Rule. Ratings for municipal issuers are available on the Internet Web sites of the rating agencies and thus issuers should be able to ascertain readily whether a rating change has occurred. In addition, issuers may be able to subscribe to a service that provides them with prompt rating updates for their securities. The Commission notes, however, that some issuers may have to monitor for these events more frequently than in the past. However, as discussed above, the Commission believes that its estimate of the time that issuers will spend, on average, to prepare and submit notices of events, including rating changes, is appropriate. With respect to the concern that some issuers will have to pay a vendor to provide them with notice of rating changes, the Commission reiterates that information regarding rating changes is available for free on the Internet Web sites of the rating agencies.

Several commenters also expressed general concerns about the costs of the amendment that eliminates the materiality condition from certain events. For example, one commenter believed that removal of the "if material" condition from some events creates a risk of dividing events into two disclosure categories that could cause confusion.<sup>618</sup> Two commenters believed that there are circumstances when an event, such as delinquent payments, are beyond an issuer's

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<sup>618</sup> See Connecticut Letter at 2.

control and do not represent a financial failure on the issuer's part.<sup>619</sup> According to these commenters, in the past they would have treated such events as immaterial.<sup>620</sup> These commenters believed that if issuers have to file notice in such circumstances, it could create an unwarranted implication that the issuer has suffered financial adversity.<sup>621</sup> Some commenters believed that the materiality qualification should be retained or included for certain specified events to prevent a large volume of notices that are irrelevant to investors' decision to buy, sell or hold municipal securities.<sup>622</sup>

In addition, several commenters expressed concerns about the costs associated with the revised disclosure item regarding adverse tax events. For example, one commenter stated that the Rule should not be expanded to include notice of routine reviews and random audits because they would unnecessarily alarm investors.<sup>623</sup> Some commenters believed that disclosure of potential taxability determinations could limit issuers' options to negotiate settlements with the IRS in ways that do not present material risk to bondholders<sup>624</sup> and could affect market perceptions of municipal issuers' securities, which would impose increased interest rates and other costs to issuers, and would limit future market access.<sup>625</sup> Some of these commenters believed that the proposal would lead to a flood of information about preliminary taxability actions<sup>626</sup> that could confuse and mislead investors<sup>627</sup> or desensitize investors regarding adverse

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<sup>619</sup> See California Letter at 2 and San Diego Letter at 2.

<sup>620</sup> Id.

<sup>621</sup> Id.

<sup>622</sup> See NABL Letter at 8 and Kutak Letter at 4.

<sup>623</sup> See Connecticut Letter at 2.

<sup>624</sup> See Metro Letter at 2, Kutak Letter at 5, and NABL Letter 7.

<sup>625</sup> See Metro Letter at 2 and Kutak Letter at 5.

<sup>626</sup> See Kutak Letter at 6.

tax event determinations.<sup>628</sup> One of these commenters suggested that event notices regarding adverse tax events should include a materiality condition.<sup>629</sup>

Furthermore, as discussed in Section III.A. above, several commenters expressed general concerns about the costs of the proposal relating to the modification of the exemption for demand securities. For example, one commenter noted that the elimination of the Rule's exemption for demand securities from the Rule would impose such insurmountable administrative costs that small issuers and non-profit organizations would refuse to enter continuing disclosure agreements.<sup>630</sup> Similarly, some commenters also believed that the elimination of the exemption for demand securities would hinder or prevent many issuers, particularly small issuers and non-profits, from using LOC-backed demand securities to access the tax-exempt markets.<sup>631</sup> They opined that local communities would be hurt as a result of the proposed amendment to delete the exemption for demand securities because small issuers and obligated persons that rely on the exemption will have to pass along to users of their service any increased costs that they may incur.<sup>632</sup> One of the commenters remarked that many non-governmental conduit borrowers<sup>633</sup> have no previous undertakings to provide continuing disclosure information and, for such persons, complying with paragraph (b)(5) of the Rule would not merely be an extension of pre-existing obligations but a new and significant burden.<sup>634</sup>

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<sup>627</sup> See Kutak Letter at 6, NABL Letter at 7, and GFOA Letter at 4.

<sup>628</sup> See Kutak Letter at 6.

<sup>629</sup> See NABL Letter at 7.

<sup>630</sup> See SIFMA Letter at 2-3.

<sup>631</sup> See CRRC Letter at 3-5, NABL Letter A-9 – A-12, and WCRRC Letter at 1.

<sup>632</sup> See CRRC Letter at 3-5 and WCRRC Letter at 1.

<sup>633</sup> See NABL Letter at A-2, n. 1.

<sup>634</sup> Id.



Moreover, two commenters stated that many obligated persons of LOC-backed demand securities do not prepare annual filings, such as audited financial statements, in the ordinary course of their business.<sup>635</sup> As discussed in the PRA section above, one of these commenters believed that they would incur \$30,000 - \$40,000 per year to prepare audited or consolidated financial statements.<sup>636</sup> The commenters therefore believed that eliminating the exemption for demand securities would impose administrative costs and burdens that could potentially force some conduit borrowers of LOC-backed demand securities to withdraw from the tax-exempt bond market.<sup>637</sup>

As discussed in Section III.A. above, the Commission has considered the comments concerning the costs and burden on demand securities issuers and obligated persons. In response to commenters' concerns, the Commission has revised the proposal relating to demand securities to include a limited grandfather provision. The Commission notes that a number of demand securities issuers and obligated persons, including some small issuers and non-profit organizations, do voluntarily enter into continuing disclosure agreements.<sup>638</sup> Further, many demand securities issuers and obligated persons are likely also to have outstanding fixed rate securities<sup>639</sup> that are subject to continuing disclosure agreements. Because any such existing continuing disclosure agreement would obligate an issuer or an obligated person to provide

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<sup>635</sup> See CRRC Letter at 5 and NABL Letter at A-2.

<sup>636</sup> See CRRC Letter at 5. See also *supra* note 539 and accompanying text.

<sup>637</sup> See CRRC Letter at 5 and NABL Letter at A-10. Two commenters also expressed concern that, in complying with the revised Rule, smaller and not-for-profit obligated persons could encounter similar administrative costs and burdens. See NABL Letter at A-2 (noting that many small businesses and non-profit organizations utilize LOC-backed demand securities in accessing the tax-exempt debt markets) and SIFMA Letter at 2-3.

<sup>638</sup> *Id.*

<sup>639</sup> See Proposing Release, *supra* note 2, 74 FR at 36837.

annual filings, event notices, or failure to file notices with respect to these fixed rate securities, providing disclosures with respect to demand securities should not be a significant additional burden for issuers and obligated persons that already have outstanding fixed rate securities.

Regarding the concern that any new disclosure burdens may induce some obligated persons to withdraw from the tax-exempt municipal market because they do not prepare annual filings in the ordinary course of their business, the Commission notes that, for purposes of the Rule, annual filings are required only to the extent provided in the final official statements.<sup>640</sup> Further, pursuant to paragraph (b)(5)(i)(B) of the Rule, audited financial statements need to be submitted, pursuant to the issuer's and obligated person's undertaking in a continuing disclosure agreement, only "when and if available."<sup>641</sup> This limitation, which is consistent with the Commission's position in the 1994 Amendments Adopting Release, should mitigate some concerns of those obligated persons that do not prepare audited financial statements in the ordinary course of their business.<sup>642</sup> Further, although not all issuers or obligated persons, in the ordinary course of their business, prepare audited financial statements or other financial and

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<sup>640</sup> See supra Section III.A. for additional discussion concerning the provision of annual filings and audited financial statements.

<sup>641</sup> 17 CFR 240.15c2-12(b)(5)(i)(B). See also supra Section III.A.

<sup>642</sup> As discussed in the 1994 Amendments Adopting Release, the 1994 Amendments "[do] not adopt the proposal to mandate audited financial statements on an annual basis with respect to each issuer and significant obligor. Instead, the amendments require annual financial information, which may be unaudited, and may, where appropriate and consistent with the presentation in the final official statement, be other than full financial statements. . . . However, if audited financial statements are prepared, then when and if available, such audited financial statements will be subject to the undertaking and must be submitted to the repositories. Thus . . . the undertaking must include audited financial statements only in those cases where they otherwise are prepared." See 1994 Amendments Adopting Release, supra note 8, 59 FR at 59599.

operating information of the type included in annual filings, a number of issuers and obligated persons do.<sup>643</sup>

The Commission acknowledges that issuers or obligated persons of demand obligations that assemble financial and operating data for the first time in response to their undertakings in a continuing disclosure agreement may incur incremental costs beyond those costs incurred by those issuers or obligated persons that already assemble this information.<sup>644</sup> Also, smaller issuers or obligated persons may have relatively greater burdens than larger issuers or obligated persons. However, the overall burdens for these demand securities issuers or obligated persons in preparing financial information are expected to be commensurate with those of issuers or obligated persons that already are preparing financial information as part of their continuing disclosure undertakings.<sup>645</sup> The Commission believes that the burdens that will be incurred in the aggregate by issuers or obligated persons, as a result of the amendments with respect to demand securities, may not be significant and, in any event, are justified by the benefits to investors of enhanced disclosure.<sup>646</sup>

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<sup>643</sup> See <http://www.emma.msrb.org> for audited financial statements or other financial and operating information submitted to EMMA.

<sup>644</sup> The Commission, however, believes that the operations of an issuer or obligated person generally entail the preparation and maintenance of at least some financial and operating data.

<sup>645</sup> Further, issuers or obligated persons that assemble financial and operating data for the first time may face a greater burden than those issuers or obligated persons that already assemble this information. The amendments therefore initially may have a disparate impact on those issuers or obligated persons, including small entities, entering into a continuing disclosure agreement for the first time, as compared with those that already have outstanding continuing disclosure agreements.

<sup>646</sup> See *supra* Section V.D. As discussed therein, some commenters believed that the amendment could force some small entities to withdraw from the tax-exempt market because: (1) disclosure of small issuers' or obligated persons' financial information would provide their large, national competitors with information about these small issuers or obligated persons, which they believed could result in a competitive disadvantage to

### 3. MSRB

Since the number of continuing disclosure documents submitted will increase as a result of the amendments, the MSRB may incur costs associated with the amendments. The Commission estimates that these costs for the MSRB may include: (i) the cost to hire additional clerical personnel at an estimated annual cost of \$119,770 to process the additional submissions associated with the amendments;<sup>647</sup> and (ii) the cost to update its EMMA system to accommodate indexing information in connection with the changes to the Rule's disclosure events. Based on information provided to the Commission staff by the MSRB staff in a telephone conversation on November 7, 2008, the MSRB staff estimated that the MSRB's costs to update its EMMA system to accommodate the final changes to the disclosure events would be approximately \$10,000.<sup>648</sup> Therefore, in connection with the amendments, the MSRB would

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them; and (2) small issuers or obligated persons would have to prepare costly audited financial statements. See, e.g., CRRC Letter at 3-4 and WCRRC Letter at 1. As discussed above, the undertakings contemplated by the amendments (and Rule 15c2-12 in general) require annual financial information only to the extent provided in the final official statement, and audited financial statements only when and if available.

<sup>647</sup> 2,030 hours (estimated additional annual number of hours worked by a compliance clerk) x \$59 (hourly wage for a compliance clerk) = \$119,770 (annual salary for compliance clerk). The \$59 per hour estimate for a compliance clerk is from SIFMA's Office Salaries in the Securities Industry 2009, modified by the Commission's staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead. The estimate for additional annual hours worked by a compliance clerk is the estimated additional hourly burden the MSRB will incur on an annual basis under the amendments. The Commission has slightly revised this cost estimate downward from the estimate contained in the Proposing Release to reflect updated hourly rate information from SIFMA for 2009. See supra Section V.D.3.

<sup>648</sup> See Proposing Release, supra note 2, 74 FR at 36855, n. 205. Telephone conversation between Harold Johnson, Deputy General Counsel, MSRB, and Martha M. Haines, Assistant Director and Chief, Office of Municipal Securities, Division, Commission, November 7, 2008.

incur a one-time cost of approximately \$10,000 as well as a recurring annual cost of approximately \$119,770.<sup>649</sup>

The Commission received a comment letter from the MSRB relating to its costs associated with the proposed amendments.<sup>650</sup> The MSRB stated that, in determining whether to approve or modify the proposed amendments, the Commission should note that changes to the manner of providing disclosures under the Rule or to the parties expected to make submissions, i.e., if third parties were to submit event notices rather than issuers or obligated persons, may have an impact on the design and timing of necessary EMMA system changes to implement the revised continuing disclosure provisions.<sup>651</sup> The MSRB also stated that the Commission should verify that any such revisions can reasonably be implemented; that the revisions would improve the efficiency, timeliness and public access process; and that no direct charges would be imposed on the MSRB for revisions such as third-party submissions.<sup>652</sup> Further, the MSRB noted that certain revisions would likely result in a longer planning, development and implementation time frame and could result in greater development and operational costs.<sup>653</sup>

C. Limited Grandfather Provision Relating to Modification of Exemption for Demand Securities

As discussed in Section III.A. above, the Commission is revising the amendment relating to demand securities from that proposed in the Proposing Release to include a limited grandfather provision, so that paragraphs (b)(5) and (c) will not apply to demand securities outstanding as of November 30, 2010. The Commission believes that the limited grandfather

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<sup>649</sup> See supra notes 487 through 490.

<sup>650</sup> See MSRB Letter at 2.

<sup>651</sup> Id.

<sup>652</sup> Id.

<sup>653</sup> Id.

provision strikes an appropriate balance between the need to improve disclosure available to investors and the recognition that the practical effects of applying paragraphs (b)(5) and (c) of the Rule to outstanding issues of demand securities could unduly burden issuers and obligated persons and thus may adversely impact the market. As the Commission noted in Section III.A. above, there would be benefits to making outstanding demand obligations subject to paragraphs (b)(5) and (c) of the Rule because greater information about these securities would be available to investors on a timely basis. However, demand securities, such as VRDOs, generally are long-term securities. If an outstanding demand security became subject to paragraph (b)(5)(i)(C) of the Rule, a Participating Underwriter, in the first remarketing of the VRDO following the compliance date of the amendments, would have to reasonably determine that an issuer or an obligated person has executed a continuing disclosure agreement to provide annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement.

For an outstanding issue of demand securities, however, referring back to information included in the final official statement may be problematic, if not impossible, because the official statement may be years old. Thus, its information would be out-of date, thereby increasing the underwriter's cost of complying with Rule 15c2-12 substantially. In addition, the official statement may be difficult to obtain if the remarketing agent was not the underwriter of the original offering. Further, absent the limited grandfathering provision, the issuer or the obligated person of such security, pursuant to its continuing disclosure undertaking, would have needed to update annual financial information that may no longer be prepared or available, which may also be a potentially costly undertaking. In addition, application of the amendments to remarketings of demand securities occurring on or after the compliance date would necessitate a large number

of issuers or obligated persons of demand securities entering into continuing disclosure agreements in a very short time period, which could delay remarketings and temporarily disrupt the markets for demand securities. The Commission believes that the benefits of applying paragraphs (b)(5) and (c) of the Rule to demand securities outstanding prior to the compliance date would not justify the high cost of such change to both Participating Underwriters and issuers or obligated persons of such securities and therefore is adopting the limited grandfather provision. The Commission further notes that some issuers or obligated persons of demand securities also have issued fixed rate municipal securities and, in that case, continuing disclosures about those issuers or obligated persons should be available to investors.

**VII. Consideration of Burden and Promotion of Efficiency, Competition, and Capital Formation**

Section 3(f) of the Exchange Act<sup>654</sup> requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act<sup>655</sup> requires the Commission, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) of the Exchange Act also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The municipal securities market is comprised of approximately 51,000 issuers that are states and local governments or their agencies and instrumentalities. As discussed in more detail

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<sup>654</sup> 15 U.S.C. 78c(f).

<sup>655</sup> 15 U.S.C. 78w(a)(2).

above, there are approximately \$400 billion of new issuances of municipal securities annually and approximately \$2.8 trillion of municipal securities are outstanding.<sup>656</sup> There are two primary types of municipal securities: general obligation bonds and revenue bonds. General obligation bonds are backed by the full faith and credit of the issuer and are also usually secured by specific tax levies. In contrast, revenue bonds are generally secured by a pledge of specific revenues of the issuer, which are typically derived from the facility financed by the bonds (for example, water rates may be used to pay principal and interest on the bonds issued to pay for construction of a water system). Revenue bonds are further divided into two general types: governmental and private purpose. Governmental bonds are issued to finance the needs of the states or local governments, their agencies and instrumentalities. Private purpose bonds (often referred to as conduit bonds), however, are issued to provide the benefit of a tax-exempt interest rate to a private entity as permitted by various provisions of the Internal Revenue Code. The obligation to pay conduit bonds rests entirely on the private borrower, such as 501(c)(3) hospitals, colleges and universities, the owners of low and moderate income housing projects and of small industrial facilities.

As described above, because of the diversity of disclosure practices, the Commission believes that the informational efficiency of the municipal bond market could be improved. As a result, the Commission believes that the amendments are appropriate to enhance the efficiency of the municipal securities market, particularly in the sense of informational efficiency. Informational efficiency helps investors efficiently allocate capital, since it helps to ensure that a security's price accurately reflects important information. When accurate information is available, the municipal security's price serves to convey aggregate information to investors,

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<sup>656</sup> See supra Section II.



further facilitating investment decisions. The amendments encourage disclosure of information that, in the Commission's view, reasonable investors consider important in their transaction decisions. The amendments strengthen the municipal disclosure process because of the new events being added to paragraph (b)(5)(i)(C) of the Rule. In addition, inclusion of the provision that submissions of event notices to the MSRB be made in a timely manner not in excess of ten business days of the event's occurrence, and the deletion of the exemption for demand securities (other than those demand securities that qualify for the limited grandfather provision), also is expected to promote the efficiency of the municipal securities market, as described above including in the cost-benefit section. Currently, the Rule does not contain a specific time frame within which event notices must be provided to the MSRB pursuant to a continuing disclosure agreement. Thus, the Commission believes that the revision relating to the time frame for submission of event notices will help individuals and others to obtain greater information about municipal securities within ten business days of the event's occurrence. In addition, certain events regarding municipal securities that may be important to investors, such as certain tender offers or the consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material, are now included as event items in the Rule. Further, certain events listed in paragraph (b)(5)(i)(C) of the Rule will now be disclosed without the issuer first having to make a materiality determination.

Moreover, the Rule's exemption for demand securities has been narrowed, although a limited grandfather provision is in place for many pre-existing demand obligations.<sup>657</sup> As a consequence of the amendments, in some cases, greater information about municipal securities and their issuers will be more readily accessible on a more timely basis to broker-dealers, mutual funds, analysts and other market professionals, institutional and retail investors, and the public generally. Thus, these individuals and entities are expected to have access to important information about municipal securities within a specific ten business day time frame, which could aid them in making better informed and more efficient investment decisions and should help reduce the likelihood of fraud facilitated by inadequate disclosure. To the extent that greater information efficiency ultimately allows for better allocation of investments in the municipal securities market, the amendments are expected to promote allocative efficiency as well.

The Commission considers the existing state of the municipal securities market to be a competitive one, given the large number and diversity of issuers, and the volume of municipal securities regularly issued and remarketed, as noted above, despite certain characteristics of municipal bonds, discussed below, that lead to a certain degree of non-fungibility and market segmentation. The size of the municipal securities market - with approximately 51,000 issuers, \$400 billion of new issuances annually, and approximately \$2.8 trillion in securities outstanding - suggest that the market for issuance and purchase of municipal securities may be highly

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<sup>657</sup> As discussed above, although it may be optimal for all outstanding demand obligations to be subject to paragraph (b)(5) and (c) of the Rule, the application of the continuing disclosure requirements of the Rule to all outstanding demand securities issued prior to the compliance date may be burdensome for issuers and Participating Underwriters because they would need to enter into a continuing disclosure agreement for any remarketing that is a primary offering that occurs on or after the compliance date, which, potentially, could temporarily disrupt the market for demand securities.

competitive. Additionally, investors can substitute to some degree their portfolios between municipal securities and other securities, particularly fixed-income securities of comparable credit quality. Depending on the municipality, these may include U.S. Treasury obligations, corporate bonds, and, more recently, taxable bonds known as Build America Bonds. Such substitutability implies that municipal issuers must currently compete not only with each other but also with other comparable opportunities available to investors. Relative to this existing competitive benchmark, the Commission believes that the amendments promote competition in the purchase and sale of municipal securities, as described below.

Because of the limited grandfather provision and the transition aspects of the amendments discussed in Section IV above, a number of issuers will have differing disclosure undertakings. In this regard, some issuers of demand securities will qualify for the limited grandfather provision. In addition, the Commission recognizes that by not applying the amendments to continuing disclosure agreements entered into prior to the amendments' compliance date, for a period of time there will be municipal securities that are subject to differing disclosure. This circumstance may cause some confusion and thus could lead to some inefficiency with respect to investors and broker-dealers who otherwise would prefer uniform disclosure. Because of the nature of the market for demand securities, the Commission does not believe that it is appropriate to impose requirements that would mandate revisions to existing continuing disclosure agreements.

The Commission believes that the amendments will promote competition in the purchase and sale of municipal securities due to the greater availability and timeliness of information as a result of the amendments. Competition is generally more robust when many willing buyers and many willing sellers transact with full information. Competition in the municipal securities

market is generally based on the premise that investors are informed of the various attributes of the investment instruments, and issuers are competing for investors. Even with multiple sellers and buyers, if there are high search costs (that is, if investors have to incur high costs to gather relevant information), these costs can be a barrier to effective competition. The Commission believes that its amendments will tend to remove this barrier. As a result, more investors may be attracted to this market sector and broker-dealers and municipal issuers can compete for their business.

The amendments are designed to encourage improvement in the completeness and timeliness of issuer disclosures and thus foster additional interest in municipal securities by retail and institutional customers. In addition, the greater availability of information about municipal securities will be beneficial to vendors of municipal securities information as they develop their value-added products. Thus, the amendments will promote competition among those vendors of municipal securities information that utilize the information provided to the MSRB pursuant to continuing disclosure agreements and compete with each other in creating and offering for sale value-added products relating to municipal securities. As discussed above,<sup>658</sup> the amendments may result in some additional cost and hourly burdens for broker-dealers, issuers and the MSRB.

By providing more timely disclosure of important information to an important segment of the capital markets as a whole, the Commission believes that these amendments also will improve the allocative efficiency of capital formation both within the municipal segment of the fixed income market and within the municipal bond market, in particular. Allocative efficiency of capital is enhanced when investors are able to make better-informed investment decisions since capital should flow to its most efficient use. The amendments will provide investors and

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<sup>658</sup> See supra Sections V.E.1. and V.E.2.

other municipal market participants with notice of additional events, to be provided in a timely manner not in excess of ten business days of the event's occurrence, and the Commission has provided a limited grandfathering provision. The Commission believes that the limited grandfather provision strikes an appropriate balance between the need to improve disclosure available to investors and the recognition that the practical effects of applying paragraphs (b)(5) and (c) of the Rule to outstanding issues of demand securities could unduly burden issuers and obligated persons and thus may adversely impact the market. In addition, the amendments will help to provide investors and other municipal market participants with access to important information about demand securities that previously were not subject to the Rule's disclosure provisions. To assess the effect of the amended Rule on capital formation, the Commission has evaluated the benefits of enhanced disclosure on the allocative efficiency of the capital market.

In the Proposing Release, the Commission considered the proposed amendments in light of the standards set forth in the above-noted Exchange Act provisions. The Commission solicited comment on whether, if adopted, the proposal would result in any anti-competitive effects or would promote efficiency, competition or capital formation. The Commission asked commenters to provide empirical data or other facts to support their views on any anti-competitive effects or any burdens on efficiency, competition or capital formation that might result from the proposed amendments. The Commission received some comments about the competitive effects of the proposed amendments.

As discussed above,<sup>659</sup> some commenters believed that the elimination of the Rule's exemption for demand securities would force some issuers, particularly small issuers and non-profit organizations, to choose between accepting the burdens of complying with the continuing

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<sup>659</sup> See supra Section III.A.

disclosure provisions of the Rule and withdrawing from the tax-exempt market.<sup>660</sup> Two of these commenters argued that the proposed amendment would have a chilling effect on competition for small issuers and obligated persons because it would favor their large national competitors that are either already reporting companies or have superior financial and employee resources to comply with the Rule.<sup>661</sup> In their view, the proposed amendment would force small and local businesses that rely on the exemption for demand securities to choose between giving up their proprietary financial information and accessing tax-exempt financing. Revelation of this financial information, in their view, would favor competitors, relative to the status quo.<sup>662</sup> They opined that there could be a negative impact on capital formation if these businesses decided to forego tax exempt financing and were unable to obtain other sources of lending and if investors were not afforded the opportunity to acquire the securities that these businesses otherwise would have issued.<sup>663</sup>

The Commission acknowledges that for those primary offerings of demand securities that no longer will be exempt from the Rule and for which the issuer is not currently submitting continuing disclosure documents to the MSRB, the practice will be different than it was prior to the amendments. In such cases, Participating Underwriters will need to reasonably determine that the issuer or obligated person has undertaken, in a continuing disclosure agreement, to provide continuing disclosure documents to the MSRB. This change applies to any initial offering and remarketing that is a primary offering of demand securities unless the limited grandfather provision applies. Those issuers that have not previously issued securities covered

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<sup>660</sup> See NABL Letter A-9 – A-12, CRRRC Letter at 3-5, and WCRRRC Letter at 1.

<sup>661</sup> See CRRRC Letter at 3-5, and WCRRRC Letter at 1.

<sup>662</sup> Id.

<sup>663</sup> See CRRRC Letter at 3-5, and WCRRRC Letter at 1.

by the Rule will be entering into a continuing disclosure agreement for the first time and thereby will incur some costs to provide continuing disclosure documents to the MSRB. Although the Commission recognizes that, if some small entities elected to forego tax-exempt financing because of the impact of the amendments, the amendments could have an adverse impact on those entities; however, it believes that any additional burden on issuers and obligated persons is, on balance, justified by the improved availability of information with respect to demand securities. This conclusion, moreover, is supported by a number of commenters.<sup>664</sup> Therefore, while the Commission is mindful of the additional burdens that may befall certain competitors in the market, based on its analysis as well as other comments submitted, the Commission continues to believe the overall result of the amendments will be to promote competition in the municipal securities market.

In addition, as the Commission previously noted, a number of issuers and obligated persons of demand securities are likely to have outstanding fixed rate securities. Some of these securities, in turn, likely would be subject to continuing disclosure agreements under the Rule. Because any existing continuing disclosure agreement would obligate an issuer or an obligated person to provide annual filings, event notices, or failure to file notices with respect to these fixed rate securities, providing disclosures with respect to demand securities is not expected to be a significant additional burden for these issuers and obligated persons.

Regarding the concern that any new disclosure burdens may induce some obligated persons to withdraw from the tax-exempt municipal market because they do not prepare annual filings in the ordinary course of their business, the Commission notes that, for purposes of the

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<sup>664</sup> See, e.g., CHEFA Letter at 2, Connecticut Letter at 1, e-certus Letter I at 11, Folt Letter at 1, ICI Letter at 5, NFMA Letter at 1, RBDA Letter at 2, and SIFMA Letter at 2.

Rule, annual filings are required only to the extent provided in the final official statement.<sup>665</sup> Further, pursuant to paragraph (b)(5)(i)(B) of the Rule, audited financial statements need to be submitted, pursuant to the issuer's and obligated person's undertaking in a continuing disclosure agreement only "when and if available."<sup>666</sup> This limitation, which is consistent with the Commission's position in the 1994 Amendments Adopting Release, should mitigate some concerns of those obligated persons that do not prepare audited financial statements in the ordinary course of their business.<sup>667</sup> Further, although not all issuers or obligated persons, in the ordinary course of their business, prepare audited financial statements or other financial and operating information of the type included in annual filings, a number of issuers and obligated persons do.<sup>668</sup>

The Commission acknowledges that issuers or obligated persons of demand obligations that assemble financial and operating data for the first time in response to their undertakings in a continuing disclosure agreement may incur incremental costs beyond those costs incurred by

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<sup>665</sup> See supra Section III.A. for additional discussion concerning the provision of annual filings and audited financial statements.

<sup>666</sup> 17 CFR 240.15c2-12(b)(5)(i)(B). See also supra Section III.A. concerning audited financial statements and 1994 Amendments Adopting Release, supra note 8, 59 FR at 59599.

<sup>667</sup> As discussed in the 1994 Amendments Adopting Release, the 1994 Amendments "[do] not adopt the proposal to mandate audited financial statements on an annual basis with respect to each issuer and significant obligor. Instead, the amendments require annual financial information, which may be unaudited, and may, where appropriate and consistent with the presentation in the final official statement, be other than full financial statements. . . . However, if audited financial statements are prepared, then when and if available, such audited financial statements will be subject to the undertaking and must be submitted to the repositories. Thus . . . the undertaking must include audited financial statements only in those cases where they otherwise are prepared." See 1994 Amendments Adopting Release, supra note 8, 59 FR at 59599.

<sup>668</sup> See <http://www.emma.msrb.org> for audited financial statements or other financial and operating information submitted to EMMA.



those issuers or obligated persons that already assemble this information.<sup>669</sup> Also, smaller issuers or obligated persons may have relatively greater burdens than larger issuers or obligated persons. However, the overall burdens for these demand securities issuers or obligated persons in preparing financial information are expected to be commensurate with those of issuers or obligated persons that already are preparing financial information as part of their continuing disclosure undertakings.<sup>670</sup> The Commission believes that the burdens that will be incurred in the aggregate by issuers or obligated persons, as a result of the amendments with respect to demand securities, may not be significant and, in any event, are justified by the benefits to investors of enhanced disclosure.<sup>671</sup>

Two commenters viewed the addition of the event item for mergers, acquisitions, and substantial asset sales as “anti-competitive,” because they believed that disclosure of such events by closely held companies prior to public announcement would allow competitors to interfere

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<sup>669</sup> The Commission, however, believes that the operations of an issuer or obligated person generally entail the preparation and maintenance of at least some financial and operating data.

<sup>670</sup> Further, issuers or obligated persons that assemble financial and operating data for the first time may face a greater burden than those issuers or obligated persons that already assemble this information. The amendments therefore initially may have a disparate impact on those issuers or obligated persons, including small entities, entering into a continuing disclosure agreement for the first time, as compared with those that already have outstanding continuing disclosure agreements.

<sup>671</sup> See supra Section V.D. As discussed therein, some commenters believed that the amendment could force some small entities to withdraw from the tax-exempt market because: (1) disclosure of small issuers’ or obligated persons’ financial information would provide their large, national competitors with information about these small issuers or obligated persons, which they believed could result in a competitive disadvantage to them; and (2) small issuers or obligated persons would have to prepare costly audited financial statements. See, e.g., CRRC Letter at 3-4 and WCRRC Letter at 1. As discussed above, the undertakings contemplated by the amendments (and Rule 15c2-12 in general) require annual financial information only to the extent provided in the final official statement, and audited financial statements only when and if available.

with the transaction.<sup>672</sup> However, the Commission believes that competition in the market for corporate control would be enhanced, not reduced, by the possibility of disclosure creating more open conditions for the sale of privately held-companies. The Commission further notes that parties to mergers and acquisition agreements generally may, subject to legal obligations, include remedies in such agreements that are designed to balance the conflicting interests of the buyer and the seller.

For the foregoing reasons, pursuant to Section 3(f) of the Exchange Act, the Commission has considered the amendments to the Rule and believes that they, on balance, should promote efficiency and capital formation and increase competition. In addition, pursuant to Section 23(a)(2) of Exchange Act, the Commission does not believe that they impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

#### VIII. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with the provisions of the Regulatory Flexibility Act ("RFA").<sup>673</sup> It relates to amendments to Rule 15c2-12<sup>674</sup> under the Exchange Act.<sup>675</sup> The amendments revise certain requirements regarding the information that a broker, dealer, or municipal securities dealer acting as an underwriter in a primary offering of municipal securities must reasonably determine that an issuer of municipal securities or an obligated person has undertaken, in a written agreement or contract for the beneficial holders of the issuer's municipal securities, to provide, and revise an

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<sup>672</sup> Id.

<sup>673</sup> 5 U.S.C. 604(a).

<sup>674</sup> 17 CFR 240.15c2-12.

<sup>675</sup> 15 U.S.C. 78a et seq. See also Proposing Release, supra note 2, 74 FR at 36836.

exemption from the rule. Specifically, the amendments: (1) require a Participating Underwriter to reasonably determine that an issuer or obligated person has agreed to provide notice of specified events in a timely manner not in excess of ten business days of the occurrence of the event; and (2) modify the list of events for which notices are to be provided. In addition, the amendments modify the condition that event notices are to be submitted to the MSRB “if material,” for some, but not all, of the Rule’s specified events. Further, the amendments revise an exemption from the Rule for demand securities, by making the offering of those securities subject to the continuing disclosure obligations set forth in the Rule. This change applies to any initial offering and remarketing that is a primary offering of demand securities occurring on or after the compliance date of the amendments.<sup>676</sup> However, to address commenters’ concerns about the impact of the amendments on existing demand securities, the amendment does not apply to remarketings of demand securities that are outstanding in the form of demand securities on the day preceding the amendments’ compliance date and that continuously have remained outstanding in the form of demand securities.

A. Need for Amendments to Rule 15c2-12

The main purpose of the amendments is to improve the availability of significant and timely information to the municipal securities markets and to help deter fraud and manipulation in the municipal securities market by prohibiting the underwriting of, and subsequent recommendation of transactions in, municipal securities for which adequate information is not available on an ongoing basis.

The amendments modify paragraphs (b)(5)(i)(C) and (d)(2)(ii)(B) of Rule 15c2-12 to require a Participating Underwriter to reasonably determine that the issuer or obligated person

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<sup>676</sup> As noted above, the compliance date of the amendments to the Rule is December 1, 2010.

has agreed in its continuing disclosure agreement to provide event notices to the MSRB in an electronic format as prescribed by the MSRB, in a timely manner not in excess of ten business days after the occurrence of any such event. Previously, the Rule stated that event notices were to be provided "in a timely manner." In 1994, the Commission adopted amendments to Rule 15c2-12 and noted at that time that it had not established a specific time frame with respect to "timely" because of the wide variety of events and issuer circumstances.<sup>677</sup> However, the Commission stated that, in general, this determination must take into consideration the time needed to discover the occurrence of the event, assess its materiality, and prepare and disseminate the notice.<sup>678</sup> It has been reported that there have been some instances in which event notices were not submitted until months after the events occurred.<sup>679</sup> The Commission believes that such delays can deny investors important information that they need to make informed decisions regarding whether to buy, sell, or hold municipal securities. Moreover, notice of important events can aid investors in determining whether the price that they pay or receive for their municipal security transactions is appropriate.<sup>680</sup>

The Commission believes that codifying in the Rule a specific time within which event notices are to be provided to the MSRB, in accordance with the continuing disclosure agreement, should result in these notices being made available more promptly than at present. Accordingly, the amendments require a broker, dealer, or municipal securities dealer (i.e., a Participating Underwriter) to reasonably determine that an issuer or obligated person has agreed, in a continuing disclosure agreement, to provide notice of the Rule's specified events in a timely

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<sup>677</sup> See 1994 Amendments, supra note 7, 59 FR at 59601

<sup>678</sup> Id.

<sup>679</sup> See Proposing Release, supra note 2, 74 FR at 36837.

<sup>680</sup> Id.

manner not in excess of ten business days after the event's occurrence. The Commission believes that this change will help promote more timely disclosure of this important information to municipal security investors.

Paragraph (b)(5)(i)(C)(6) of the Rule currently requires Participating Underwriters reasonably to determine that the issuer or obligated person has entered into a continuing disclosure agreement to submit a notice for "[a]dverse tax opinions or events affecting the tax-exempt status of the security." The Commission is adopting, with certain modifications from that proposed, an amendment to paragraph (b)(5)(i)(C)(6) of the Rule to require that Participating Underwriters reasonably determine that the issuer or obligated person has entered into a continuing disclosure agreement to submit a notice for "[a]dverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security." A determination by the IRS that interest on a municipal security may, in fact, be taxable not only could reduce the security's market value, but also could adversely affect each investor's federal and, in some cases, state income tax liability.<sup>681</sup> The tax-exempt status of a municipal security is also important to many mutual funds whose governing documents, with certain exceptions, limit their investments to tax-exempt municipal securities.<sup>682</sup> Therefore, retail and institutional investors alike are very interested in events that could adversely affect the tax-exempt status of the municipal securities that they own or may wish to purchase.<sup>683</sup>

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<sup>681</sup> See Proposing Release, supra note 2, 74 FR at 36840-41.

<sup>682</sup> Id.

<sup>683</sup> Id.

Under the Rule, as amended, a materiality determination is no longer necessary for the following six existing events: (1) principal and interest payment delinquencies with respect to the securities being offered; (2) unscheduled draws on debt service reserves reflecting financial difficulties; (3) unscheduled draws on credit enhancements reflecting financial difficulties; (4) substitution of credit or liquidity providers, or their failure to perform; (5) defeasances; and (6) rating changes.<sup>684</sup> The Commission believes that these events are of such importance to investors that notice of their occurrence should always be provided pursuant to a continuing disclosure agreement. Furthermore, the Commission believes that eliminating the necessity to make a materiality decision upon the occurrence of these events will simplify issuer compliance with the terms of their continuing disclosure agreements and will help to make such filings available more promptly to investors and others.

The amendments also add the following events, for which disclosure notices are to be provided pursuant to a continuing disclosure agreement: (i) tender offers (paragraph (b)(5)(i)(C)(8) of the Rule);<sup>685</sup> (ii) bankruptcy, insolvency, receivership or similar event of the obligated person (paragraph (b)(5)(i)(C)(12) of the Rule);<sup>686</sup> (iii) the consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material (paragraph (b)(5)(i)(C)(13) of the Rule);<sup>687</sup> and (iv) appointment of a successor or additional trustee, or the

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<sup>684</sup> See Proposing Release, supra note 2, 74 FR at 36839-40.

<sup>685</sup> See Proposing Release, supra note 2, 74 FR at 36842-46.

<sup>686</sup> Id.

<sup>687</sup> Id.

change of name of a trustee (paragraph (b)(5)(i)(C)(14) of the Rule), if material.<sup>688</sup> The Commission believes that there is a need to make available to all investors this important information because it can affect their investment decisions and the value of their municipal securities. The Commission further believes that the addition of these four events disclosure items to the Rule will substantially improve the availability of important information in the municipal securities market.

Finally, the amendments modify the Rule's exemption for demand securities by eliminating paragraph (d)(1)(iii) to Rule 15c2-12 and adding new paragraph (d)(5) to the Rule. The Commission's experience with the operation of the Rule and changes in the municipal securities market suggest a need to increase the availability of information to investors regarding demand securities.<sup>689</sup> Furthermore, the recent period of turmoil in the market for municipal auction rate securities and demand securities also suggests that the Rule's exemption for demand securities is no longer appropriate and that the exemption should be modified to apply paragraphs (b)(5) and (c) of the Rule, relating to the submission of continuing disclosure documents and recommendations by brokers, dealers, and municipal securities dealers, respectively, to primary offerings of demand securities.<sup>690</sup>

#### B. Objectives

The purpose of the amendments is to achieve more efficient, effective, and wider availability of municipal securities information to broker-dealers, mutual funds, analysts and other market professionals, institutional and retail investors, and the public generally, and to help

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<sup>688</sup> Id.

<sup>689</sup> See Proposing Release, supra note 2, 74 FR at 36835-37.

<sup>690</sup> Id.

prevent, fraudulent, deceptive, or manipulative acts or practices in the municipal securities market.

C. Significant Issues Raised by Public Comment

In the Proposing Release, the Commission requested comment on matters discussed in the IRFA.<sup>691</sup> No commenter suggested that the Rule would have a significant impact on smaller broker-dealers, who are not entities directly subject to the Rule. As discussed in greater detail above, several commenters raised concerns regarding the impact of the proposed amendments on small issuers, although they are not directly subject to the rule.<sup>692</sup>

D. Small Entities Subject to the Rule

The amendments apply directly to any broker, dealer, or municipal securities dealer that acts as a Participating Underwriter in a primary offering of municipal securities with an aggregate principal amount of \$1,000,000 or more and indirectly issuers of such securities.

The RFA defines "small entity" to mean "small business," "small organization," or "small government jurisdiction."<sup>693</sup> The Commission's rules define "small business" and "small organization" for purposes of the RFA for each of the types of entities the Commission regulates.

A broker-dealer is a small business if its total capital (net worth plus subordinated liabilities) on the last day of its most recent fiscal year was \$500,000 or less, and is not affiliated with any entity that is not a "small business."<sup>694</sup>

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<sup>691</sup> See Proposing Release, *supra* note 2, 74 FR at 36867.

<sup>692</sup> See CRRC Letter, WCRRRC Letter, Kutak Letter, CHEFA Letter, NAHEFFA Letter, Connecticut Letter, SIFMA Letter, NABL Letter, and GFOA Letter. See *supra* Sections III.B., III.E., and V.D.

<sup>693</sup> 5 U.S.C. 601(6).

<sup>694</sup> 17 CFR 240.0-10(c).



A municipal securities dealer that is a bank (including a separately identifiable department or division of a bank) is a small business if it has total assets of less than \$10 million at all times during the preceding fiscal year; had an average monthly volume of municipal securities transactions in the preceding fiscal year of less than \$100,000; and is not affiliated with any entity that is not a "small business."<sup>695</sup>

For purposes of Commission rulemaking, an issuer or person, other than an investment company, is a "small business" or "small organization" if its "total assets on the last day of its most recent fiscal year were \$5 million or less."<sup>696</sup>

Based on information obtained by the Commission's staff, the Commission estimates that 250 broker-dealers, including municipal securities dealers, would be Participating Underwriters within the meaning of Rule 15c2-12.<sup>697</sup> Based on a recent review of industry sources, the Commission does not believe that any Participating Underwriters would be small broker-dealers or municipal securities dealers.<sup>698</sup> The Commission did not receive any comments on this issue.

A "small governmental jurisdiction" is defined by the RFA to include "governments of cities, counties, towns, townships, villages, school districts, or special districts, with a population of less than fifty thousand."<sup>699</sup> Currently, there are approximately 51,000 state and local issuers of municipal securities<sup>700</sup> that are subject to the amendments. The Commission estimates that approximately 40,000 state and local issuers are "small" entities for purposes of the RFA.

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<sup>695</sup> 17 CFR 240.0-10(f).

<sup>696</sup> 17 CFR 230.157. See also 17 CFR 240.0-10(a).

<sup>697</sup> See supra Section V.C.

<sup>698</sup> See Proposing Release, supra note 2, 74 FR at 36866.

<sup>699</sup> 5 U.S.C. 601(5).

<sup>700</sup> See Securities Exchange Act Release No. 33741 (March 9, 1994), 59 FR 12748 (March 17, 1994).

However, the Commission believes that most issuers of municipal securities qualify for the limited exemption in paragraph (d)(2) of the Rule.<sup>701</sup> In the 2008 Amendments Adopting Release, the Commission estimated that 10,000 issuers would enter into continuing disclosure agreements that provide for their submitting continuing disclosure documents to the MSRB.<sup>702</sup> Under the amendment to narrow the Rule's exemption for demand securities, the number of affected issuers is estimated to increase to 12,000 issuers.<sup>703</sup> Some of these issuers may be small issuers.

In the Proposing Release, the Commission requested comment on the above estimates. The Commission received no comments responding to these estimates and continues to believe that they are appropriate.

E. Reporting, Recordkeeping and other Compliance Requirements

The amendments apply to all small entities that are currently subject to Rule 15c2-12. Because small entities already may submit notices to the MSRB to disclose events already covered by the Rule, these entities should be able to prepare notices for events that are incorporated into the Rule by the amendments. The Commission expects that adding the new disclosure events will increase costs incurred by small entities, to the extent that their primary offerings of municipal securities are covered by the Rule, because they potentially will have to provide a greater number of event notices than they do currently.

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<sup>701</sup> Specifically, Rule 15c2-12(d)(2) provides an exemption from the application of paragraph (b)(5) of the Rule (Rule's provision regarding Participating Underwriters obligations with respect to continuing disclosure agreements) with respect to primary offerings if, among other things, the issuer or obligated person has agreed to a limited disclosure obligation, including sending certain material event notices to the MSRB. See 17 CFR 240.15c2-12(d)(2).

<sup>702</sup> See 2008 Adopting Release, supra note 7, 73 FR at 76121.

<sup>703</sup> See Proposing Release, supra note 2, 74 FR at 36850.

F. Action to Minimize Effect on Small Entities and Consideration of Alternatives

In connection with the final revisions to the Rule, the Commission considered the above comments and the following alternatives:

- (1) Establishing differing compliance or reporting requirements or timetables which take into account the resources available to smaller entities;
- (2) Exempting smaller entities from coverage of the disclosure requirements, or any part thereof;
- (3) The clarification, consolidation, or simplification of disclosure for small entities; and
- (4) Use of performance standards rather than design standards.

As noted above, breaker-dealers who are the entities directly subject to the Rule are not likely to be significantly affected by the amendments. The Commission notes, however, that it has adopted a delayed compliance date of December 1, 2010, to allow broker-dealers, and other entities indirectly affected by the Rule, additional time to familiarize themselves with the amendments and to give the MSRB time to make the necessary system changes to its EMMA system. As for issuers who are not directly subject to the Rule, the Commission notes that Rule 15c2-12 currently provides differing compliance criteria for larger and smaller issuers because most small issuers of municipal securities are eligible for the limited exemption currently contained in paragraph (d)(2) of the Rule. The exemption in Rule 15c2-12(d)(2) provides that paragraph (b)(5) of the Rule, which relates to the submission of continuing disclosure documents, does not apply to a primary offering if the conditions contained therein are met.<sup>704</sup> This limited exemption from the Rule is intended to assist small governmental jurisdictions that

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<sup>704</sup> See 17 CFR 240.15c2-12(d)(2).

issue municipal securities. In the case of primary offerings by small governmental jurisdictions that are not covered by the exemption, the Commission notes that the amendments balance the informational needs of investors and others with regard to municipal securities issued by small governmental jurisdictions with the impact effects of the amendments on such small issuers.<sup>705</sup>

Further, the Commission believes that, in the case of those issuers that do not qualify for the exemption in paragraph (d)(2) of the Rule and that issue securities after the amendments compliance date, there should be comparable standards for municipal securities disclosure events. The Commission nevertheless recognizes that by not applying the amendments to continuing disclosure requirements entered into prior to the amendments' compliance date, for a period of time there will be municipal securities that are subject to differing disclosure. The Commission is mindful of the potential difficulties presented by revising continuing disclosure agreements that reflect contractual commitments entered into by the municipal issuer at the time of the security's issuance. These differences in disclosure that will result from applying the amendments to new issuances and not to municipal securities outstanding prior to the compliance date will, however, diminish over time. With respect to the clarification, consolidation, or simplification of disclosure for small entities, the Commission notes that, although the amendments are uniform for large and small issuers, they are largely based on existing requirements.

#### **IX. Statutory Authority**

Pursuant to the Exchange Act, and particularly Sections 2, 3(b), 10, 15(c), 15B, 17 and 23(a)(1) thereof, 15 U.S.C. 78b, 78c(b), 78j, 78o(c), 78o-4, 78q and 78w(a)(1), the Commission

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<sup>705</sup> The Commission also notes that the Rule's exemption for primary offerings of municipal securities that have an aggregate principal amount of less than \$1,000,000 may also apply to small issuers and small governmental jurisdictions. See 17 CFR 240.15c2-12(a).

is adopting amendments to § 240.15c2-12 of Title 17 of the Code of Federal Regulations in the manner set forth below.

**Text of Rule Amendments**

**List of Subjects in 17 CFR Part 240**

Brokers, Reporting and recordkeeping requirements, Securities.

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

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

1. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*

2. Section 240.15c2-12 is amended by the following:

- A. Revise the introductory text of paragraph (b)(5)(i)(C), and paragraphs (b)(5)(i)(C)(2),(6), (7), (8), (10), and (11);
- B. Add new paragraphs (b)(5)(i)(C)(12), (13) and (14);
- C. Revise paragraph (d)(1)(ii);
- D. Remove paragraph (d)(1)(iii);
- E. Revise paragraph (d)(2)(ii)(B); and
- F. Add new paragraph (d)(5).

The additions and revisions read as follows.

**§ 240.15c2-12 Municipal securities disclosure.**

\* \* \* \* \*

(b) \* \* \*

(5)(i) \* \* \*

(C) In a timely manner not in excess of ten business days after the occurrence of the event, notice of any of the following events with respect to the securities being offered in the Offering:

\* \* \* \* \*

(2) Non-payment related defaults, if material;

\* \* \* \* \*

(6) Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the security, or other material events affecting the tax status of the security;

(7) Modifications to rights of security holders, if material;

(8) Bond calls, if material, and tender offers;

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(10) Release, substitution, or sale of property securing repayment of the securities, if material;

(11) Rating changes;

(12) Bankruptcy, insolvency, receivership or similar event of the obligated person;

Note to paragraph (b)(5)(i)(C)(12): For the purposes of the event identified in subparagraph (b)(5)(i)(C)(12), the event is considered to occur when any of the following occur: the appointment of a receiver, fiscal agent or similar officer for an obligated person in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state or federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the obligated person, or if such jurisdiction has been assumed by leaving the existing governing body and officials or officers in possession but subject to the supervision and orders of a court or governmental authority, or the entry of an order confirming a plan of reorganization, arrangement or liquidation by a court or governmental authority having supervision or jurisdiction over substantially all of the assets or business of the obligated person;

(13) The consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material;

(14) Appointment of a successor or additional trustee or the change of name of a trustee, if material; and

\* \* \* \* \*

(d) \* \* \*

(1) \* \* \*

(ii) Have a maturity of nine months or less.

\* \* \* \* \*

(2) \* \* \*

(ii) \* \* \*

\* \* \* \* \*

(B) In a timely manner not in excess of ten business days after the occurrence of the event, notice of events specified in paragraph (b)(5)(i)(C) of this section with respect to the securities that are the subject of the Offering; and

\* \* \* \* \*

(5) With the exception of paragraphs (b)(1) - (4), this section shall apply to a primary offering of municipal securities in authorized denominations of \$100,000 or more if such securities may, at the option of the holder thereof, be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent; provided, however, that paragraphs (b)(5) and (c) shall not apply to such securities outstanding on November 30, 2010 for so long as they continuously remain in authorized denominations of \$100,000 or more and may, at the option of the holder thereof, be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent.

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**PART 241 - INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER**

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3. Part 241 is amended by adding Release No. 34-62184A and the release date of May 26, 2010 to the list of interpretative releases.

By the Commission.

*Elizabeth M. Murphy*  
Elizabeth M. Murphy  
Secretary

Dated: May 26, 2010

Note: Exhibit A to the Preamble will not appear in the Code of Federal Regulations

Exhibit A

Key to Comment Letters Cited in Adopting Release  
Amendment to Municipal Securities Disclosure  
(File No. S7-15-09)

1. Letter from Bill Boatwright, Wealth Advisor, UBS Financial Services, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated July 16, 2009 ("Boatwright Letter").
2. Letter from James R Folts, Investor, to Elizabeth M. Murphy, Secretary, Commission, dated August 4, 2009 ("Folts Letter").
3. Letter from Leonard Becker, Investor, to Elizabeth M. Murphy, Secretary, Commission, dated August 12, 2009 ("Becker Letter").
4. Letter from Charles Halgren, Financial Analyst, to Elizabeth M. Murphy, Secretary, Commission, dated August 18, 2009 ("Halgren Letter").
5. Letter from Philip A. Shalanca, Retired School Business Administrator, to Elizabeth M. Murphy, Secretary, Commission, dated August 30, 2009 ("Shalanca Letter").
6. Letter from Glenn Byers, Assistant Treasurer and Tax Collector, County of Los Angeles, to Mary Schapiro, Chairman, Commission, dated August 31, 2009 ("Los Angeles Letter").
7. Letter from Kenneth L. Rust, Chief Administrative Officer, City of Portland, Oregon ("Portland") and Eric H. Johansen, Debt Manager, Portland, to Elizabeth M. Murphy, Secretary, Commission, dated September 1, 2009 ("Portland Letter").
8. Letter from Jerry Moffatt, State President, California Refuse Recycling Council ("CRRC"), Doug Button, North District President, CRRC, to Elizabeth M. Murphy, Secretary, Commission, dated September 2, 2009 ("CRRC Letter").
9. Letter from Lisa S. Good, Executive Director, National Federation of Municipal Analysts ("NFMA"), to Elizabeth M. Murphy, Secretary, Commission, dated September 2, 2009 ("NFMA Letter").
10. Letter from Connecticut Health and Educational Facilities Authority ("CHEFA"), to Elizabeth M. Murphy, Secretary, Commission, dated September 4, 2009 ("CHEFA Letter").
11. Letter from Robert Donovan, Executive Director, Rhode Island Health and Educational Building Corporation, on behalf of the National Association of Health and Education

- Facilities Finance Authorities ("NAHEFFA"), to Elizabeth M. Murphy, Secretary, Commission, dated September 4, 2009 ("NAHEFFA Letter").
12. Letter from Brian G. Thomas, Assistant General Manager/Chief Financial Officer, The Metropolitan Water District of Southern California ("Metro Water"), to Elizabeth M. Murphy, Secretary, Commission, dated September 4, 2009 ("Metro Water Letter").
  13. Letter from Trish Roath, Executive Director, CRRC, Kristan Mitchell, Executive Director, Oregon Refuse & Recycling Association, and Brad Lovas, Executive Director, Washington Refuse & Recycling Association, on behalf of West Coast Refuse & Recycling Coalition ("WCRRC"), to Elizabeth M. Murphy, Secretary, Commission, dated September 7, 2009 ("WCRRC Letter").
  14. Letter from Ronald A. Stack, Chair, Municipal Securities Rulemaking Board ("MSRB"), to Elizabeth M. Murphy, Secretary, Commission, dated September 8, 2009 ("MSRB Letter I").
  15. Letter from Richard T. McNamar, President, e-certus, Inc. ("e-certus"), to Elizabeth M. Murphy, Chairman, Commission, dated September 8, 2009 ("e-certus Letter I").
  16. Letter from Leon J. Bijou, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association ("SIFMA"), to Elizabeth M. Murphy, Secretary, Commission, dated September 8, 2009 ("SIFMA Letter").
  17. Letter from Michael Decker, Co-Chief Executive Officer, Regional Bond Dealers Association ("RBDA"), and Mike Nicholas, Co-Chief Executive Officer, RBDA, to Elizabeth M. Murphy, Secretary, Commission, dated September 8, 2009 ("RBDA Letter").
  18. Letter from Denise L. Nappier, Treasurer, State of Connecticut, to Elizabeth M. Murphy, Secretary, Commission, dated September 8, 2009 ("Connecticut Letter").
  19. Letter from Daniel C. Lynch, Kutak Rock LLP, to Elizabeth M. Murphy, Secretary, Commission, dated September 8, 2009 ("Kutak Letter").
  20. Letter from Tom Sanzillo, Consultant, T.R. Rose Associates, Mark Kresowick, Corporate Accountability Representative, Sierra Club, and Lisa Anne Hamilton, Counsel, to Elizabeth M. Murphy, dated September 8, 2009 ("T.R. Rose and Sierra Letter").
  21. Letter from Paula Stuart, Chief Executive Officer, Digital Assurance Certification, LLC ("DAC"), to Elizabeth M. Murphy, Secretary, Commission, dated September 8, 2009 ("DAC Letter").
  22. Letter from Karrie McMillan, General Counsel, Investment Company Institute ("ICI"), to Elizabeth M. Murphy, Secretary, Commission, dated September 8, 2009 ("ICI Letter").

23. Letter from Mark Paxson, General Counsel, Office of California State Treasurer, to Elizabeth M. Murphy, Secretary, Commission, dated September 8, 2009 ("California Letter").
24. Letter from Donald F. Steuer, Chief Financial Officer, County of San Diego, to Elizabeth M. Murphy, Secretary, Commission, dated September 8, 2009 ("San Diego Letter").
25. Letter from Scott C. Goebel, Senior Vice President and General Counsel, FMR Co., Fidelity Investments ("Fidelity"), to Elizabeth M. Murphy, Secretary, Commission, dated September 11, 2009 ("Fidelity Letter").
26. Letter from William A. Holby, President, National Association of Bond Lawyers ("NABL"), to Elizabeth M. Murphy, Secretary, Commission, dated September 23, 2009 ("NABL Letter").
27. Letter from Frank R. Hoadley, Chairman, Governmental Debt Management Committee, Government Finance Officers Association ("GFOA"), to Elizabeth M. Murphy, Secretary, Commission, dated September 24, 2009 ("GFOA Letter").
28. Letter from Richard T. McNamar, President, e-certus, Inc. ("e-certus"), to Elizabeth M. Murphy, Secretary, Commission, dated October 14, 2009 ("e-certus Letter II").
29. Letter from Peter Lehner, Executive Director, Natural Resources Defense Council ("NRDC"), to Elizabeth M. Murphy, Secretary, Commission, dated December 15, 2009 ("NRDC Letter").

Chairman Schapiro  
not participating

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934  
Rel. No. 62178 / May 26, 2010

Admin. Proc. File No. 3-13678

In the Matter of the Application of

JOHN M.E. SAAD  
Law Office of Gregory Bartko, LLC  
c/o Gregory Bartko, Esq.  
3475 Lenox Road, Suite 400  
Atlanta, GA 30326

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DISCIPLINARY  
PROCEEDINGS

Misappropriation

Registered securities association found that registered representative, while associated with member firm, intentionally filed a false reimbursement claim and misappropriated member firm's funds. *Held*, association's findings of violations and sanctions are *sustained*.

APPEARANCES:

*Gregory Bartko, Esq.*, for John M.E. Saad.

*Marc Menchel, Gary Dernelle, and Carla Carloni*, for the Financial Industry Regulation Authority, Inc.

Appeal filed: November 4, 2009  
Last brief received: February 17, 2010

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## I.

John M.E. Saad, formerly a registered representative associated with Homer, Townsend & Kent ("HTK"), a FINRA member firm, appeals from FINRA disciplinary action.<sup>1</sup> FINRA found that Saad misappropriated funds of HTK's parent company, member firm Penn Mutual Life Insurance Co. ("Penn Mutual"), in violation of NASD Rule 2110 by accepting reimbursement based on Saad's submission of false expense reimbursement requests and receipts. FINRA barred Saad in all capacities and assessed costs.<sup>2</sup> We base our findings on an independent review of the record.

## II.

The parties do not dispute the underlying facts in this matter. In the summer of 2006, Saad served as Penn Mutual's regional director in Atlanta, Georgia, and was registered with Penn Mutual's broker-dealer affiliate, HTK, as an investment company products and variable contracts limited representative, general securities representative, and general securities principal. Saad testified at his disciplinary hearing that his chief duties were recruiting insurance agents to sell Penn Mutual's insurance products as independent contractors and helping existing Penn Mutual independent contractors build their business.

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<sup>1</sup> On July 26, 2007, we 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 certain 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. Although the investigation into Saad's misconduct was initiated before the consolidation, the complaint was filed afterwards. For simplicity's sake, we refer only to FINRA.

<sup>2</sup> NASD Rule 2110 requires that members "observe high standards of commercial honor and just and equitable principles of trade."

As part of the effort to consolidate and reorganize NASD's and NYSE's rules into one FINRA rulebook, NASD Rule 2110 (which was otherwise unchanged) was codified as FINRA Rule 2010, effective December 15, 2008. See FINRA Regulatory Notice 08-57 (Oct. 2008). Because the conduct at issue occurred before NASD Rule 2110 was codified as FINRA Rule 2010, we will continue to refer to NASD Rule 2110. NASD Rule 2110 is applicable to Saad through NASD General Rule 115 (now FINRA Rule 140), which provides that persons associated with a member have the same duties and obligations as a member. See generally *Kirlin Sec., Inc.*, Exchange Act Rel. No. 61135 (Dec. 10, 2009), 97 SEC Docket 23299, 23300 n.4 (describing NASD Rules 2110 and 140 with respect to the rule consolidation).

Saad's career at Penn Mutual started promisingly. He was a large producer, traveled extensively on recruiting trips, and earned various production awards. By the end of 2005, however, Saad's production declined, to the point he "had almost halted travel for a period of time." By June 2006, Saad received a production warning from Penn Mutual. During his disciplinary hearing, Saad blamed his drop in productivity on an illness of one of his year-old twin sons, although he acknowledged that he neither told his employer about his son's health problems nor requested time off as a result.

#### **A. Saad's Fabricated Receipts and False Expense Report**

Saad testified that, the month after receiving the production warning, he had "a really good recruiting opportunity" in Memphis, Tennessee, scheduled for Monday, July 10, 2006. Saad testified that he intended to travel to Memphis the day before the meeting. On the way to the airport, however, he learned the meeting had been canceled. Upon learning of the canceled meeting, Saad "panicked because my travel was down dramatically." Saad testified that he instead checked into an Atlanta-area hotel for two nights: Sunday, July 9 and Monday, July 10. Saad explained that he did not go into the office during this time "[b]ecause I had told me [sic] staff that I was going to be in Memphis. I was concerned with the fact that when that appointment cancelled, that if I had gone to the office, that it would have been evident that I hadn't done any travel."

Two weeks later, Saad flew to Penn Mutual's home office, where, Saad testified, "they formally told me, essentially, that it was a 60-day production warning." He explained, "Essentially, I was told that production had fallen, and they needed to see results."

A week after this production warning, Saad submitted his July expense report for processing. Typically, Saad paid office expenses and overhead directly out of an office account into which Penn Mutual wired \$6,300 at the beginning of each month. However, for expenses Saad incurred personally, including travel, Saad would submit a month-end expense report, along with receipts, to the office administrator, who would then submit the materials to Penn Mutual. Once approved, Saad would transfer the approved amount out of the office account into his personal account or use that money to pay his credit card bill directly.

By the time Saad submitted his July expense report, he "felt total pressure . . . to show that this recruiting trip [to Memphis] had occurred." He added, "I had to show that I was somewhere because the only way that the home office could verify my travel or work ethic or whatever was being questioned was on my expense reports." Saad submitted an expense report that included a receipt of \$478 for a round-trip airline itinerary, showing travel from Atlanta to Memphis on July 9, 2006 and returning on July 11, 2006. Saad also included a hotel receipt of \$274.44 that showed a two-night stay in a Memphis-area hotel for July 9 though July 11, 2006. These receipts, of course, were fakes. Saad admitted that he fabricated them by copying information and company logos from the Internet.

Unrelated to the claimed Memphis trip, Saad also submitted a \$392.19 receipt for the purchase of a cell phone, dated July 14, 2006. The section on the receipt indicating the name of the cell phone recipient was blacked out, and a handwritten note on the receipt stated: "new cell phone, old Treo broke." Saad acknowledged writing the note on the receipt, but could not recall whether he had blacked out the recipient's name (although, he acknowledged during his investigative "on-the-record" testimony, "I'm assuming I probably did").

Regardless of whether he blacked out the name, Saad admitted he had not purchased the cell phone to replace his phone. He instead purchased the phone for Magdaline Moser, an insurance agent affiliated with Aflac, Inc.'s Atlanta office. Saad testified that he hoped to recruit Moser to sell Penn Mutual products and that, in exchange for the cell phone, Moser would introduce him to other prospects in Aflac's Atlanta office.

Saad stated that he had never before purchased a cell phone for someone he was recruiting, but claimed "I had the right to expense items that I felt necessary to help them with their production." He also claimed that he had purchased other equipment, such as laptops, for people he was recruiting and "thought that a cell phone is something that could have helped with [Moser's] production." When asked why – if the expense was legitimate, as he claimed – he altered the receipt instead of just submitting it at face value, Saad responded, "if I put down that I spent a cell phone [sic] for a new rep, then, you know, I just wanted – you know, I was under the pressure of the situation that I just said, you know, I'm just going to put it down as my own, but I should have put it down as exactly the way it should have been put down and expensed it that way." The Hearing Panel, "having observed Respondent's demeanor while testifying," did not find credible Saad's claim that his purchase of a cell phone for Moser "was consistent with previously approved business equipment." Moreover, Saad stated during his on-the-record testimony that his purchase of a cell phone for Moser "probably wouldn't have been" an approved expense.

#### **B. Discovery of Saad's Falsified Expense Report**

The falsehoods in Saad's expense report might have gone unnoticed, except Saad also submitted an authentic, unaltered receipt for four drinks purchased on Sunday evening, July 9, at an Atlanta hotel lounge. The office administrator questioned Saad about the drink receipt, noting it showed Saad was in Atlanta – not Memphis – on the evening of July 9. Saad withdrew the receipt and threw it away, because, he explained, "if she [the office administrator] knew that I was in Atlanta, then it wouldn't help my production."

The office administrator retrieved the receipt from the trash. She submitted it, along with her concerns, to Penn Mutual's home office, writing that Saad's receipts for Memphis were part of a "BOGUS TRIP." When Penn Mutual approached Saad about his claimed expenses, Saad



admitted he had not gone to Memphis. He offered to reimburse Penn Mutual, but Penn Mutual declined reimbursement and terminated him.<sup>3</sup>

### C. FINRA Investigation

Approximately two months after Saad was terminated, FINRA asked Saad to provide information about his discharge by HTK and whether he improperly submitted expense reports for expenses not actually incurred, and, if so, why.<sup>4</sup> Saad responded that, "[a]fter an extensive audit, it was determined that on my July 2006 expense report a charge of under \$750 for a business trip that had yet to occur was posted." He added, "I must stress that I was given authority to manage expenses for more than \$75,000 annually over the past 5 ½ years (over \$350,000). It is an under \$750 business expense from one (1) expense report that Penn Mutual has found to be 'improperly submitted' after an extensive audit."

Approximately six months later, in April 2007, a FINRA examiner telephoned Saad to ask again about his termination. According to a FINRA file memorandum about that conversation, Saad acknowledged "HTK's issue with the airfare and hotel expense is valid," but claimed that he did not know Moser and that he did not know why HTK was questioning his cell phone expense. Saad, however, later admitted buying the cell phone for Moser during his on-the-record testimony.

In July 2007, FINRA informed Saad that it would bring a disciplinary proceeding against him for "submitting false expense reports to Penn Mutual, the parent company of [HTK], and receiving reimbursement to which you were not entitled, in violation of NASD Conduct Rule 2110." FINRA wrote that, if Saad wished to settle the matter, he could sign an enclosed Letter of Acceptance, Waiver and Consent, pursuant to which Saad would "consent to the imposition of a bar from the securities industry."

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<sup>3</sup> HTK also terminated Saad, effective September 16, 2006. Saad testified at his disciplinary hearing that he was then associated with National Life Insurance Company, but not registered to sell securities.

<sup>4</sup> The Office of Insurance for the Commonwealth of Kentucky ("Kentucky Office of Insurance") also asked Saad to provide a detailed response to "a complaint involving your actions as an agent." Saad answered that, "[a]fter an extensive audit, [Penn Mutual] determined that on my July 2006 expense report a charge of under \$750 for a business trip that had yet to occur was posted." Saad added, "I asked [Penn Mutual] if I could repay the isolated expense deemed 'improperly submitted' but they declined to accept my offer. They in turn decided to terminate my employment." The Kentucky Office of Insurance informed Saad approximately six weeks later that, "[a]t this time, there is insufficient evidence to support administrative action against you."

Saad declined FINRA's offer, and FINRA filed a complaint against Saad in September 2007. The complaint contained one cause of action: "Conversion of Funds" in violation of NASD Rule 2110. The specific allegations were that "Saad submitted false expense reports and receipts to Penn Mutual . . . resulting in payments to Saad of \$1,144.63 to which he was not entitled," including the false airline, hotel, and cell phone expenses. The complaint concluded, "Such acts, practices and conduct constitute separate and distinct violations of NASD Conduct Rule 2110."

#### **D. FINRA Hearing and Appeal**

A FINRA hearing panel (the "Hearing Panel") held a disciplinary hearing on April 16, 2008. Saad admitted to falsifying receipts, submitting a falsified expense report, and, as a result, receiving \$1,144.63 in reimbursement. Saad explained that he had purchased the cell phone "for an individual that I was recruiting, and I felt I had the latitude to make that call." He added, "with regard to the Memphis trip, I feel that I was basically not where I should have been, but at the same time was here working for good reason under the pressure that I was under felt that, unfortunately, I had to do that."

Before Saad testified, FINRA presented testimony from the examiner who conducted the investigation into Saad's conduct. The examiner testified, in part, that there was "no question whatsoever" that Saad initially denied knowing Moser. When Saad was also asked during his hearing about whether he had denied knowing Moser, he responded, "I don't recall making that comment. At that time, if I – if it was a situation I was being questioned, I had no idea – you know, all these questions, I mean, they could have been asked, I just don't remember any at that time." Saad urged the Hearing Panel "to give me some consideration with my family and my career on the line, that you could look at this situation where it wasn't necessarily that funds were converted, but a situation where it was more of an accounting misnomer that occurred."

In a decision dated August 19, 2008, the Hearing Panel found Saad had "deliberately decided to deceive his employer in two separate reimbursement transactions, once with the false travel expenses and again with the cell phone." The panel concluded that Saad "converted Penn Mutual's funds, in violation of NASD Conduct Rule 2110, when he obtained reimbursement for fictitious expenses," and assessed costs and imposed a bar in all capacities, noting that "[a]ccording to the *FINRA Sanction Guidelines*, a bar is standard for conversion regardless of the amount converted."

Saad appealed to FINRA's National Adjudicatory Council ("NAC"), which affirmed the Hearing Panel's findings of violations and sanctions. The NAC found "that Saad's deceitful conduct was premeditated and egregious." The NAC also noted that, unlike the Hearing Panel, "[w]e have not based our sanctions on a finding that Saad converted Penn Mutual's funds. Instead, we base our decision on the fact that no mitigating factors exist." This appeal followed.

## III.

NASD Rule 2110 requires associated persons to "observe high standards of commercial honor and just and equitable principles of trade." As we have held, "conduct that reflects negatively on an applicant's ability to comply with regulatory requirements fundamental to the securities industry is inconsistent with just and equitable principles of trade."<sup>5</sup> FINRA's disciplinary authority under NASD Rule 2110 is also "broad enough to encompass business-related conduct that is inconsistent with just and equitable principles of trade, even if that activity does not involve a security."<sup>6</sup>

Here, Saad admits he intentionally falsified receipts, submitted a fraudulent expense report, and accepted \$1,144.63 in unentitled reimbursement. Saad's submission of the falsified expense report, and resulting financial benefit, reflects negatively on both Saad's ability to comply with regulatory requirements and his ability to handle other people's money. The entry of accurate information in firm records is a foundation for FINRA's regulatory oversight of its members, and "[i]t is critical that associated persons, as well as firms, comply with this basic requirement."<sup>7</sup> We thus find Saad's conduct to be inconsistent with just and equitable principles of trade and that, as a result, Saad violated NASD Rule 2110.<sup>8</sup>

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<sup>5</sup> *Geoffrey Ortiz*, Exchange Act Rel. No. 58416 (Aug. 22, 2008), 93 SEC Docket 8977, 8986; *see also Vail v. SEC*, 101 F.3d 37, 39 (5th Cir. 1996) (per curiam) (affirming Commission's finding that representative violated just and equitable principles of trade by misappropriating funds belonging to a political club while serving as that organization's treasurer), *aff'g*, 52 S.E.C. 339, 342 (1995) (holding that "Vail commingled his and the Club's funds for the sake of his own personal convenience" and, in doing so, "make[s] us doubt his commitment to the high fiduciary standards demanded by the securities industry"); *Daniel D. Manoff*, 55 S.E.C. 1155, 1162 (2002) ("Conduct Rule 2110 applies when the misconduct reflects on the associated person's ability to comply with the regulatory requirements of the securities business and to fulfill his fiduciary duties in handling other people's money.").

<sup>6</sup> *Vail*, 101 F.3d at 39; *see also Manoff*, 55 S.E.C. at 1162 (noting that application of Rule 2110 to business-related conduct not involving a security "is well-established"); *Thomas E. Jackson*, 45 S.E.C. 771, 772 (1975) ("Although [applicant's] wrongdoing in this instance did not involve securities, the NASD could justifiably conclude that on another occasion it might.").

<sup>7</sup> *Charles E. Kautz*, 52 S.E.C. 730, 734 (1996) (stating that "regardless of his Firm's policy or knowledge . . . it is a violation of NASD Rules to enter false information on official Firm records"); *see also Ortiz*, 93 SEC Docket at 8986-87 (finding that representative violated NASD Rule 2110 by submitting false information to his employer, a member firm).

<sup>8</sup> *See, e.g., Manoff*, 55 S.E.C. at 1161 (finding that representative's unauthorized use of co-worker/customer's credit card numbers violated just and equitable principles of trade);

(continued...)

## IV.

Saad does not dispute any relevant facts and expressly admits "that his actions violated NASD Rule 2110." He nevertheless challenges the proceeding because, he claims, FINRA "failed to give him clear notice of the specific charge alleged." Saad claims FINRA violated his due process rights by labeling the sole cause of action in its complaint as "Conversion," but subsequently sanctioning him on a basis other than conversion. He claims he was "rendered incapable of preparing an appropriate defense," and he analogizes FINRA's "actions [as] tantamount to a Judge deciding to convict a defendant of bank fraud when the defendant was only charged with and provided a defense against money laundering." We disagree.

"As long as a party to an administrative proceeding is reasonably apprised of the issues in controversy and is not misled, notice is sufficient."<sup>9</sup> Here, FINRA specified in its complaint that Saad had violated Rule 2110 by submitting false expense reports and receipts to Penn Mutual and receiving, as a result, \$1,144.63 in unentitled reimbursement. Saad, who was represented by counsel since at least the time FINRA issued its complaint, had a full opportunity to defend himself against these factual allegations, which he admitted.<sup>10</sup> FINRA staff also notified Saad

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<sup>8</sup> (...continued)

*James A. Goetz*, 53 S.E.C. 472, 477-78 (1998) (finding that representative violated just and equitable principles of trade by misleading his member firm into believing he had contributed \$1,600 in personal funds to a private school to procure a matching gift in that amount for the school).

<sup>9</sup> *Janet Gurley Katz*, Exchange Act Rel. No. 61449 (Feb. 1, 2010), \_\_\_ SEC Docket \_\_\_, \_\_\_ (quoting *Steven E. Muth*, Exchange Act Rel. No. 52551 (Oct. 3, 2005), 86 SEC Docket 1217, 1233 n.40), *appeal filed*, No. 10-1068 (D.C. Cir. Mar. 26, 2010); *see also Aloha Airlines, Inc. v. Civil Aeronautics Bd.*, 598 F.2d 250, 262 (D.C. Cir. 1979) (noting that, in administrative proceedings, "[i]t is sufficient if the respondent 'understood the issue' and 'was afforded full opportunity' to justify its conduct during the course of the litigation") (quoting *NLRB v. Mackay Radio & Tel. Co.*, 304 U.S. 333, 350 (1938)); *Kevin M. Glodek*, Exchange Act Rel. No. 60937 (Nov. 4, 2009), 97 SEC Docket 22027, 22036 (noting that self-regulatory organizations, such as FINRA, generally "are not state actors and thus are not subject to the Constitution's due process requirements"), *appeal filed*, No. 09-5325 (2d Cir. Dec. 28, 2009).

<sup>10</sup> *See William C. Piontek*, 57 S.E.C. 79, 90-91 (2003) (finding that respondent who "understood the issue[s]" and "'was afforded full opportunity' to litigate" them had sufficient notice of the charges against him (quotations and citations omitted)); *Jonathan Feins*, 54 S.E.C. 366, 378 (1999) ("Administrative due process is satisfied where the party against whom the proceeding is brought understands the issues and is afforded a full opportunity to meet the charges during the course of the proceeding.").

before filing the complaint that they believed a bar was an appropriate sanction for his conduct.<sup>11</sup> Saad cites to no argument or evidence that his supposed lack of notice prevented him from introducing.<sup>12</sup> We thus conclude Saad was adequately aware of the issues in controversy and the potential sanctions involved.<sup>13</sup>

## V.

Saad further challenges the sanction imposed as excessive. Exchange Act Section 19(e)(2) directs us to sustain FINRA's sanctions unless we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive, oppressive, or impose an

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<sup>11</sup> FINRA's position was also consistent with the range of sanctions recommended by the FINRA Sanction Guidelines. *See infra* notes 25-27 and accompanying text.

<sup>12</sup> Saad claims "[t]he initial charge of Conversion of Funds put [him] in the unenviable position of starting at the worst sanction and trying to justify a lesser sanction," and he spends a substantial portion of his appeal arguing that his conduct did not amount to conversion. We need not address those issues. The NAC did not find that Saad's misconduct amounted to conversion, and we review only the NAC's decision on appeal. *See Philippe N. Keyes*, Exchange Act Rel. No. 54723 (Nov. 8, 2006), 89 SEC Docket 792, 800 n.17 ("[I]t is the decision of the NAC, not the decision of the Hearing Panel, that is the final action of NASD which is subject to Commission review.").

<sup>13</sup> In his initial Application for Review to the Commission, Saad asserted that FINRA's introduction of the drink receipt was part of an overall bias "obstruct[ing] Mr. Saad's right to a fair and impartial hearing." Although the drink receipt was included in the parties' joint exhibit, Saad argued that FINRA's tactics, including introduction of the drink receipt, was evidence that, "[f]rom the onset, this was clearly a trial of adultery and not an administrative proceeding of securities violation(s) or the protection of the public." Saad also argued in his Application for Review that FINRA had misled him about his need for an attorney during his on-the-record interview with FINRA's enforcement staff. The FINRA examiner who interviewed Saad, however, denied that she ever advised Saad that he did not need an attorney, and the letter summoning Saad to appear for the on-the-record interview (along with the accompanying addendum) included several statements advising Saad that he could be represented by counsel.

Saad did not mention these two arguments in his Opening Brief to the Commission, and in his Reply Brief, he stated, "though he still believes in those arguments, he understands he waived those arguments." After conducting our *de novo* review of the record, we find that these two arguments concerning bias and Saad's on-the-record testimony provide no basis for overturning FINRA's decision.

unnecessary or inappropriate burden on competition.<sup>14</sup> Saad contends that his actions here warranted a "much less severe sanction" and asserts that, in barring him, FINRA placed him "in the same category of risk to the public as those individuals who actually misused or converted customer funds, some of whom were not even barred." Saad supports his claims by pointing to what he asserts are (i) inconsistencies between FINRA's sanction determination here and those made in other FINRA disciplinary proceedings; (ii) a misapplication of relevant FINRA sanction guidelines; and (iii) mitigating circumstances. We discuss each in turn.

#### A. Prior Disciplinary Proceedings

Saad cites nearly fifty FINRA disciplinary actions (the majority of which are settlements) he believes "illustrates the unconscionable result reached in this case."<sup>15</sup> Saad notes, for example, that FINRA agreed to impose a two-year suspension on another representative who allegedly submitted inaccurate travel and expense reports and, as a result, obtained approximately \$600 from his member firm.<sup>16</sup> Saad asks why, if FINRA was willing to settle for a two-year suspension in that case, his offer to settle for a similar sanction "was not acceptable in his case."<sup>17</sup>

It is well established, however, that the appropriateness of a sanction "depends on the facts and circumstances of each particular case and cannot be precisely determined by comparison with action taken in other proceedings."<sup>18</sup> "This is especially true with regard to

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<sup>14</sup> 15 U.S.C. § 78s(e)(2). Saad does not allege, and the record does not show, that FINRA's action imposed an undue burden on competition.

<sup>15</sup> The sanctions imposed in these actions ranged from as short as ten days to as long as a bar.

<sup>16</sup> *Gary Steven Swiman*, FINRA Case No. 2008012094801 (2009) (accepting settlement of a two-year suspension).

<sup>17</sup> Saad states in his brief that he submitted an offer of settlement to FINRA on December 27, 2007 "that provided for three months of suspension, a \$5,000 fine, and restitution."

<sup>18</sup> *Paz Sec., Inc.*, Exchange Act Rel. No. 57656 (Apr. 11, 2008), 93 SEC Docket 5122, 5134 (citing *Butz v. Glover Livestock Comm'n Co.*, 411 U.S. 182, 187 (1973) ("The 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.")), *petition denied*, 566 F.3d 1172 (D.C. Cir. 2009); *see also Geiger v. SEC*, 363 F.3d 481, 488 (D.C. Cir. 2004) ("The Commission is not obligated to make its sanctions uniform, so we will not compare this sanction to those imposed in previous cases."); *Hiller v. SEC*, 429 F.2d 856,

settled cases, where, as we have frequently pointed out, pragmatic factors may result in lesser sanctions."<sup>19</sup>

## B. Application of Sanction Guidelines

Saad next asserts that FINRA misapplied its own Sanction Guidelines when it relied on the Sanction Guideline for "conversion or improper use of funds." Saad claims his "actions, though admittedly wrong, constituted falsification of records and do not constitute conversion or improper use of funds." He argues FINRA instead should have consulted the guideline for "falsification of records."

Saad, however, did more than just falsify an expense report. He also misappropriated employer funds, and FINRA may consider all the facts and circumstances surrounding the misconduct at issue when deciding to impose a bar.<sup>20</sup> Saad alleges that the guideline for improper use applies only to misconduct involving the misuse of "customer funds" – which his misconduct did not involve. However, the guideline for "improper use of funds" is not so limited.<sup>21</sup> While the guideline cites NASD Rule 2330 (which prohibits members from making "improper use of a customer's funds or securities") as one of the rules violations to which the guideline applies, the guideline also states that it applies to violations of NASD Rule 2110, the

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<sup>18</sup> (...continued)

858 (2d Cir. 1970) ("[W]e cannot disturb the sanctions ordered in one case because they were different from those imposed in an entirely different proceeding.").

<sup>19</sup> *Anthony A. Adonnino*, 56 S.E.C. 1273, 1295 (2003), *aff'd*, 111 Fed. Appx. 46 (2d Cir. 2004); *see also Gary Kornman*, Exchange Act Rel. No. 59403 (Feb. 19, 2009), 95 SEC Docket 14246, 14260-61 (affirming bar and rejecting applicant's comparison to an allegedly similar, settled matter that involved a lesser sanction), *aff'd*, 592 F.3d 173 (D.C. Cir. 2010).

<sup>20</sup> *Cf. Katz*, \_\_ SEC Docket at \_\_ (finding NYSE had not erred when it based its imposition of a bar, in part, on conduct not charged in the complaint); *J. Stephen Stout*, 54 S.E.C. 888, 915 n.64 (Oct. 4, 2000) (finding respondent's ongoing involvement in an arbitration scheme to be relevant when deciding to affirm a bar because his conduct "pose[d] a high risk of future securities law violations"); *Joseph J. Barbato*, 53 S.E.C. 1259, 1282 (1999) (finding respondent's contact of Division witnesses to be relevant when deciding to affirm a bar because respondent's conduct suggested he may commit future violations).

<sup>21</sup> Saad's only authority for his interpretation of the guideline for "improper use" is a case from the United States Court of Appeals for the Ninth Circuit, *Carter v. SEC*, which Saad claims "describ[es] the NASD Conduct Rule 'Improper Use of Funds' as misuse of customer funds not rising to conversion." 726 F.2d 472 (9th Cir. 1983). *Carter*, however, does not involve, or even mention, NASD Rule 2330, "misuse of funds," or "conversion." *See Carter*, 726 F.2d at 473-74.

rule at issue here. Moreover, the guidelines make clear they "are not intended to be absolute" and, "[f]or violations that are not addressed specifically, Adjudicators are encouraged to look to the guidelines for analogous violations."<sup>22</sup> The sanction guidelines, in other words, "merely provide a 'starting point' in the determination of remedial sanctions."<sup>23</sup>

FINRA reasonably determined here that the guideline for improper use was the most analogous, and we have affirmed sanctions that relied on that guideline in similar circumstances.<sup>24</sup> Furthermore, FINRA's decision to impose a bar is consistent with either guideline. The guideline for improper use, which FINRA used, recommends a bar unless "the improper use resulted from respondent's misunderstanding of his or her customer's intended use of the funds or securities, or other mitigation exists."<sup>25</sup> The guideline for falsification of records recommends a bar in "egregious" cases and a lesser sanction only in cases "where mitigating factors exist."<sup>26</sup> Here, FINRA found Saad's conduct to be "egregious" and "that no mitigating factors exist." FINRA's decision to impose a bar was thus consistent with the guideline for either conversion or falsification of records.<sup>27</sup>

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<sup>22</sup> FINRA Sanction Guidelines 1 (2007 ed.), available at <http://www.finra.org/web/groups/enforcement/documents/enforcement/p011038.pdf>.

<sup>23</sup> *Hattier, Sanford & Reynoir*, 53 S.E.C. 426, 433 n.17 (1998) (affirming fine in excess of guideline's recommended range), *aff'd*, 163 F.3d 1356 (5th Cir. 1998); *see also Peter C. Bucchieri*, 52 S.E.C. 800, 806 (1996) ("NASD's guidelines are not meant to prescribe fixed penalties but merely to provide a 'starting point' in the determination of remedial sanctions.").

<sup>24</sup> *See Manoff*, 55 S.E.C. at 1165-66 & n.16 (noting that "[b]ecause there was no specific NASD Sanction guideline that applied to the unauthorized use of credit cards, the NASD relied on the guideline for 'Conversion or Improper Use'"); *Eliezer Gurfel*, 54 S.E.C. 56, 63 n.15 (1999) (affirming bar for forging signature on firm's commission checks and depositing funds in personal bank account that fell within the range of both the Sanction Guideline for "conversion or improper use" and "forgery and/or falsification of records"), *petition denied*, 205 F.3d 400 (D.C. Cir. 2000).

<sup>25</sup> Sanction Guidelines, at 38.

<sup>26</sup> Sanction Guidelines, at 39.

<sup>27</sup> "Although the Commission is not bound by the Guidelines, we use them as a benchmark in conducting our review under Exchange Act Section 19(e)(2)." *CMG Institutional Trading, LLC*, Exchange Act. Rel. No. 59325 (Jan. 30, 2009), 95 SEC Docket 13802, 13814 n.38.



### C. Mitigating Factors

Saad finally contends that "the record supports that indisputable mitigating factors exist pursuant to the Guidelines which neither FINRA nor the NAC chose to address." In particular, Saad argues that his misconduct was an "aberrant" lapse in judgment and that, "[w]hile he is not looking for a reward for doing what he should have been doing, it is important to note that he engaged in this conduct during an extremely short period of his career while he was under severe stress with a hospitalized infant and a stressful job environment." He claims FINRA also failed to consider that HTK had fired him before FINRA detected his misconduct and that his misconduct did not involve customers or large amounts of money.<sup>28</sup>

FINRA, however, devotes several pages of its opinion to rejecting Saad's various mitigation claims. FINRA expressly rejected the notion that "Saad's misconduct is essentially a one-time lapse in judgment." FINRA detailed Saad's decision "to allow his staff and Penn Mutual to believe he traveled to Memphis" and his continued willingness to be "less than fully truthful during the initial phases of FINRA's and other regulators' investigations of this matter." As FINRA observed, Saad also "had many opportunities to reverse his initial lapse in judgment." But, "[r]ather than expose himself, he chose to compound his lies with an ongoing and intentional charade in support of which he fabricated documents." FINRA also noted that an otherwise clean disciplinary history was not mitigating<sup>29</sup> and that, "[a]lthough Saad's wrongdoing in this instance did not involve customer funds or securities, Saad's willingness to lie to Penn Mutual and HTK and obtain funds to which he was not entitled indicates a troubling disregard for fundamental ethical principles which, on other occasions, may manifest itself in a customer-related or securities-related transaction."<sup>30</sup>

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<sup>28</sup> See Sanction Guidelines, at 7 (stating that a FINRA adjudicator should consider, among other things, (i) whether the member firm disciplined the respondent for the misconduct at issue prior to regulatory detection, (ii) the "number, size and character of the transactions at issue," and (iii) "the level of sophistication of the injured or affected customer").

<sup>29</sup> See, e.g., *Manoff*, 55 S.E.C. at 1165-66 (rejecting claim that lack of disciplinary record justifies conduct).

<sup>30</sup> See, e.g., *Gurfel*, 54 S.E.C. at 58, 64 (affirming bar where former registered representative converted firm's commission checks to his own use); *Leonard J. Ialeggio*, 53 S.E.C. 601, 605 (1998) ("[T]hat Ialeggio abused only his employer's trust is not mitigative."), *aff'd*, 185 F.3d 867 (9th Cir. 1999) (Table); *Mayer A. Amsel*, 52 S.E.C. 761, 768 (1996) (affirming bar despite the fact that "no customer suffered as a result of any of his actions"); *Ronald H. V. Justiss*, 52 S.E.C. 746, 750 (1996) (finding bar to be warranted because, although applicant's misconduct "did not involve direct harm to customers, it flouts the ethical standards to which members of this industry must adhere").

Saad engaged in highly troubling conduct that raises serious doubts about his fitness to work in the securities industry, "a business that is rife with opportunities for abuse."<sup>31</sup> Saad lied to his employer about going on a recruiting trip, and he fabricated receipts, submitted a falsified expense report, and accepted unjustified reimbursement as a result of that lie. Saad also sought reimbursement for a cell phone he misled his employer into believing he purchased for himself through a falsified receipt and expense report, and Saad attempted, at least initially, to recoup money he spent at an Atlanta-area hotel lounge at the same time he claimed he was in Memphis. After his employer caught and fired him, Saad further misled investigators by telling them he sought reimbursement for a trip that "had yet to occur" and by denying that he had purchased the cell phone for someone other than himself.<sup>32</sup> As FINRA summarized, "Saad's actions reveal a willingness to construct false documents and then lie about them that suggests that his continued participation in the securities industry poses an unwarranted risk to the investing public."<sup>33</sup>

Imposition of a bar is not intended to punish Saad, but "to protect the public interest from future harm at his hands."<sup>34</sup> Saad's behavior, including accepting reimbursement based on false

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<sup>31</sup> *Amsel*, 52 S.E.C. at 768 (affirming bar where applicant "exhibited a disturbing disregard for the standards that govern the securities industry").

<sup>32</sup> Saad attempts to explain some of his statements to investigators by arguing that, "[i]n the initial investigation, Saad was not represented by a lawyer, was very concerned about the repercussions of his statements and he cannot be faulted for being cautious with his statements." At best, however, these excuses explain Saad's failure to remember certain details when FINRA first interviewed him. They do not explain Saad's misleading claims about whether he sought reimbursement for an upcoming trip or his outright lie about buying the cell phone for himself. "Providing false information in any form, be it data submitted to the clearing process, or forms or testimony to a self-regulatory organization, is an especially serious matter." *Hal S. Herman*, 55 S.E.C. 395, 405 (2000) (affirming bar and noting that representative's submission of false information "emphas[izes] the appropriateness of the sanction imposed here").

<sup>33</sup> See, e.g., *Ortiz*, 93 SEC Docket at 8989-90 (affirming bar where representative attempted to conceal misconduct by supplying false information during an investigation); *Gregory W. Gray, Jr.*, Exchange Act Rel. No. 60361 (July 22, 2009), 96 SEC Docket 19038, 19053 (affirming imposition of sanctions by considering aggravating factors, including that applicant sought to conceal his conduct); *Fox & Co. Invs.*, Exchange Act Rel. No. 52697 (Oct. 28, 2005), 86 SEC Docket 1895, 1912-13 (finding imposition of a bar to be neither excessive or oppressive where applicants, among other things, concealed their conduct); *Robin Bruce McNabb*, 54 S.E.C. 917, 928-29 (2000) (sustaining bar where applicant attempted to conceal his misconduct), *aff'd*, 298 F.3d 1126 (9th Cir. 2002).

<sup>34</sup> *Conrad P. Seghers*, Investment Advisers Act Rel. No. 2656 (Sept. 26, 2007) 91 SEC Docket 2293, 2307 (quoting *Leo Glassman*, 46 S.E.C. 209, 212 (1975)) (affirming bar

(continued...)

receipts and efforts to conceal his misconduct, provides no assurance he will not repeat his violations. A bar will prevent Saad from putting customers at risk and will serve as a deterrent to others in the securities industry who might engage in similar misconduct.<sup>35</sup>

For these reasons, we find that FINRA's decision to bar Saad is neither excessive nor oppressive and that the sanction serves a remedial rather than punitive purpose.

An appropriate order will issue.<sup>36</sup>

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

Elizabeth M. Murphy  
Secretary

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

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<sup>34</sup> (...continued)

despite respondent's suggestion that the Commission should consider "the financial circumstances and hardship suffered by Seghers and his family" by noting, in part, "that the sanctions that we impose are not intended to punish"), *petition denied*, 548 F.3d 129 (D.C. Cir. 2008); *see also William Louis Morgan*, 51 S.E.C. 622, 629-30 (1993) (affirming bar despite applicant's claim "that because of the bar he and his family are suffering undue hardship").

<sup>35</sup> *See McCarthy v. SEC*, 406 F.3d 179, 190 (2d Cir. 2005) (noting that deterrent value is a relevant factor in deciding sanctions); *see also, e.g., Manoff*, 55 S.E.C. at 1165-66 (affirming bar for using another's credit card numbers to effect unauthorized transactions); *Herman*, 55 S.E.C. at 405 (affirming bar and noting that "[p]roviding false information in any form . . . emphas[izes] the appropriateness of the sanction imposed here"); *Gurfel*, 54 S.E.C. at 63-64 (affirming bar for misappropriating firm's insurance commissions).

<sup>36</sup> We have considered all of the arguments advanced by the parties. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed herein.

UNITED STATES OF AMERICA  
before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Rel. No. 62178 / May 26, 2010

Admin. Proc. File No. 3-13678

In the Matter of the Application of

JOHN M.E. SAAD  
Law Office of Gregory Bartko, LLC  
c/o Gregory Bartko, Esq.  
3475 Lenox Road, Suite 400  
Atlanta, GA 30326

For Review of Disciplinary Action Taken by

FINRA

ORDER SUSTAINING DISCIPLINARY ACTION

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

ORDERED that the disciplinary action taken by the Financial Industry Regulation Authority, Inc. against John M.E. Saad be, and hereby is, sustained.

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. 3031 / May 26, 2010**

**ADMINISTRATIVE PROCEEDING**

**File No. 3-13912**

**In the Matter of**

**LYDIA CAPITAL, LLC,**

**Respondent.**

**ORDER INSTITUTING  
ADMINISTRATIVE PROCEEDINGS  
PURSUANT TO SECTION 203(e) OF THE  
INVESTMENT ADVISERS ACT OF 1940,  
MAKING FINDINGS, AND IMPOSING  
REMEDIAL SANCTIONS**

**I.**

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") against Lydia Capital, LLC ("Respondent" or "Lydia Capital").

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(e) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

**III.**

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

1. Lydia Capital, a Delaware limited liability company located in Boston, Massachusetts, was organized in or about February 2006. It has been registered with the

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Commission as an investment adviser pursuant to Section 203(c) of the Advisers Act since February 24, 2006. Evan K. Andersen and Glenn Manterfield were the two members and principals of Lydia Capital. At all times relevant to this matter, Lydia Capital was the investment adviser to Lydia Capital Alternative Investment Fund LP (the "Fund"), a hedge fund located in Boston, Massachusetts and a Delaware limited partnership.

2. On May 18, 2010, a final judgment was entered by consent against Lydia Capital, permanently enjoining it from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act, in a civil action entitled Securities and Exchange Commission v. Lydia Capital, LLC, et al., Civil Action No. 07-CV-10712-RGS, in the United States District Court for the District of Massachusetts.

3. The Commission's amended complaint alleged, among other things, that Lydia Capital, through its principals, sold limited partnership interests and retained investors in the Fund through a series of material misrepresentations and omissions, including but not limited to: (1) materially overstating, and in some instances completely fabricating the Fund's performance; (2) inventing business partners, offices, and investors in an attempt to legitimize the firm and concealing the truth as to why key vendors and banks ceased relationships with the Respondent; (3) making material misstatements and omissions about the significant criminal history of one of Lydia Capital's partners and principals, and failing to disclose a February 2007 criminal asset freeze in England; (4) making material misstatements and omissions about how the Fund planned to address certain material risks and failing to disclose others; and (5) misstating the nature of the Fund's assets and its investment process. In addition, the Commission's amended complaint alleged that Lydia Capital, through its principals, took approximately \$4.7 million of Fund assets to which they were not entitled.

#### IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(e) of the Advisers Act, that the registration of Respondent Lydia Capital, LLC be, and hereby is, revoked.

By the Commission.

Elizabeth M. Murphy  
Secretary

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

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 62180 / May 26, 2010

INVESTMENT ADVISERS ACT OF 1940  
Release No. 3030 / May 26, 2010

ADMINISTRATIVE PROCEEDING  
File No. 3-13674

In the Matter of

JAMES E. OTTO

Respondent.

**ORDER MAKING FINDINGS AND  
IMPOSING REMEDIAL SANCTIONS AND  
CEASE-AND-DESIST ORDER PURSUANT  
TO SECTIONS 15(b) AND 21C OF THE  
SECURITIES EXCHANGE ACT OF 1934  
AND SECTIONS 203(f) AND 203(k) OF THE  
INVESTMENT ADVISERS ACT OF 1940**

I.

On November 4, 2009, the Securities and Exchange Commission ("Commission") instituted an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") ("OIP") in this matter against James E. Otto ("Otto" or "Respondent"). Respondent has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 and Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Order"), as set forth below.

II.

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

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### Summary

1. From 2004 through the present, Otto has acted as a broker-dealer without being registered as required. In 2006, with respect to certain accounts maintained at the broker-dealer TD Ameritrade, Otto violated the Exchange Act in connection with certain securities transactions he effected in the accounts. Further, Otto also acted as an investment adviser to an individual (the "Advisory Client"), and, on multiple occasions, contacted TD Ameritrade, where the Advisory Client maintained an account, pretending to be the Advisory Client.

### Respondent

2. Otto, age 51, is a resident of Overland Park, Kansas. From approximately 1986 through 2002, Otto was employed as a registered representative of several registered broker-dealers. Otto was barred from the industry for two months in 2002 by the New York Stock Exchange and he did not associate with another registered broker-dealer thereafter. At all times relevant to these proceedings Otto was licensed to sell insurance products in the states of Missouri and Kansas.

### Otto's Conduct

3. Otto acted as a broker-dealer by directing sales of securities held in numerous accounts maintained at TD Ameritrade and another registered broker-dealer by individuals who were his insurance clients and the insurance clients of other insurance salespeople. Otto directed the sales of the securities to generate cash for the clients' purchase of insurance products from him and the other insurance salespeople. The clients gave Otto information, such as PIN numbers, for the accounts at TD Ameritrade and the other broker-dealer. Otto was thereby able to access the accounts via the Internet and direct the sales of the securities. Otto was paid commissions on his sales of insurance products to these clients. In addition, the other insurance salespeople shared with Otto their commissions on their sales of insurance products to these clients.

4. Through this conduct, Otto willfully violated Section 15(a) of the Exchange Act.

5. On April 11, 2006, TD Ameritrade sent Otto a letter terminating its business relationship with him. On June 12, 2006, TD Ameritrade sent Otto a letter confirming that its termination of its relationship with him barred him from having authorization or power of attorney on any TD Ameritrade accounts, from facilitating or authorizing others to conduct activities through TD Ameritrade, and from accessing any TD Ameritrade account or allowing others to access those accounts on his behalf.

6. Notwithstanding these communications from TD Ameritrade, between April 12, 2006, and March 25, 2007, Otto accessed TD Ameritrade accounts hundreds of times by using PIN numbers and other information provided to him by the account holders, which was intended to



allow the holders access to the accounts. While accessing the accounts, Otto effected securities transactions on numerous occasions.

7. Through this conduct, Otto willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

8. In 2002, Otto entered into an arrangement with the Advisory Client in which he facilitated a transfer of the Advisory Client's securities to an account at TD Ameritrade and acquired trading authority on that account. From 2002 through 2007, Otto traded the securities in the Advisory Client's TD Ameritrade account. The Advisory Client paid Otto a management fee of 1% of the assets in the TD Ameritrade account, with a payment of 1.5% of assets if Otto doubled the S&P 500.

9. On March 19, 2007, Otto called TD Ameritrade and claimed to be the Advisory Client. Otto provided TD Ameritrade with the last four digits of the Advisory Client's social security number as identification. Posing as the Advisory Client, Otto attempted to facilitate the payment of his advisory fee through issuance of a check from the Advisory Client's account to Otto in the amount of \$1,300. The Advisory Client had authorized the issuance of the check to Otto, but did not specifically authorize Otto to call TD Ameritrade and identify himself as the Advisory Client.

10. On March 28, 2007, Otto called TD Ameritrade and again claimed to be the Advisory Client. Otto provided TD Ameritrade with the last four digits of the Advisory Client's social security number, the Advisory Client's date of birth and identified one of the stocks held in the Advisory Client's account in order to confirm to TD Ameritrade that he was the Advisory Client. In this call, Otto requested assistance in accessing the Advisory Client's TD Ameritrade account via the Internet. The Advisory Client did not specifically authorize Otto to call TD Ameritrade and identify himself as the Advisory Client.

11. Otto called TD Ameritrade on at least two other occasions and claimed to be the Advisory Client without the Advisory Client's specific authorization.

12. Through this conduct, Otto willfully violated Sections 206(1) and (2) of the Advisers Act.

### III.

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

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act and Sections 203(f) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent Otto cease and desist from committing or causing any violations and any future violations of Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act.

B. Respondent Otto be, and hereby is barred from association with any broker, dealer, or investment adviser.

C. 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  
Secretary

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

*Commissioner Casey  
Not participating*

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934  
Release No. 62186 / May 27, 2010

INVESTMENT ADVISERS ACT OF 1940  
Release No. 3032 / May 27, 2010

INVESTMENT COMPANY ACT OF 1940  
Release No. 29288 / May 27, 2010

ADMINISTRATIVE PROCEEDING  
File No. 3-13913

In the Matter of

DAVID E. ZILKHA,

Respondent.

ORDER INSTITUTING CEASE-AND-  
DESIST PROCEEDINGS PURSUANT  
TO SECTION 21C OF THE  
SECURITIES EXCHANGE ACT OF  
1934 AND ADMINISTRATIVE  
PROCEEDINGS PURSUANT TO  
SECTION 203(f) OF THE  
INVESTMENT ADVISERS ACT OF  
1940 AND SECTION 9(b) OF THE  
INVESTMENT COMPANY ACT OF  
1940

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest (i) that public cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and (ii) that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") and Section 9(b) of the Investment Company Act of 1940 ("ICA") against David E. Zilkha ("Respondent" or "Zilkha").

II.

After an investigation, the Division of Enforcement alleges that:

A. SUMMARY

1. This matter concerns insider trading in the securities of Microsoft Corporation ("Microsoft") in April 2001 by Zilkha, then a Microsoft employee who had

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accepted an employment offer from Pequot Capital Management, Inc. ("Pequot"), a registered investment adviser. On Friday, April 6, 2001, amidst rumors that Microsoft would miss its earnings estimates for the quarter that had ended on March 31 (the "Third Quarter"), Pequot's chairman and chief executive officer, Arthur J. Samberg ("Samberg"), emailed Zilkha seeking information about whether Microsoft would meet its estimates. That weekend, Zilkha contacted colleagues at Microsoft and learned that Microsoft would meet or beat those estimates. He promptly conveyed to Samberg a recommendation to purchase Microsoft securities based on this material, nonpublic information. On April 9, 2001 and thereafter, Samberg traded in Microsoft options on behalf of funds managed by Pequot with the expectation that Microsoft's stock price would rise.

2. On April 19, 2001, after the market had closed, Microsoft announced its Third Quarter earnings. Consistent with the information Zilkha had conveyed to Samberg, Microsoft beat its earnings estimates. Microsoft's stock closed at \$69 per share on April 20, the first trading day after the announcement, a rise of 96 cents per share from the close the previous day and of \$12.43 per share from the morning of April 9. As a result of the trading by Samberg and Pequot, the Pequot funds received gains of \$14,769,960, approximately \$4.1 million of which were attributable to stakes held by Pequot and Samberg in the funds and to certain performance and management fees they generated.

3. By virtue of his conduct, Zilkha willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

**B. RESPONDENT**

4. *David E. Zilkha*, age 41, currently a resident of Southbury, Connecticut, was a Microsoft employee from approximately July 20, 1998 until May 7, 2001. From approximately August 15, 2000 until his departure from Microsoft, he was a product manager within its MSN division. Starting in or about January 2001, Zilkha was seeking to become associated with Pequot, an investment adviser. On February 28, 2001, Pequot extended an employment offer to Zilka, which he accepted on March 4, 2001. Zilkha was employed by Pequot from April 23, 2001 until November 16, 2001.

**C. OTHER RELEVANT ENTITIES AND PERSONS**

5. *Pequot Capital Management, Inc.* is an investment adviser incorporated in Connecticut. It was headquartered in Westport, Connecticut until May 2009, at which time its offices were moved to Wilton, Connecticut. Pequot has been registered with the Commission since 1998 as an investment adviser.

6. *Arthur J. Samberg*, age 69, a resident of Ossining, New York, has been Chairman and CEO of Pequot since its founding in 1998.

7. *Microsoft Corporation* is a public company incorporated and headquartered in Redmond, Washington. Its securities trade on the NASDAQ and are registered under

Section 12(g) of the Exchange Act. It has traded at all pertinent times under the ticker symbol, "MSFT."

**D. ALLEGATIONS**

**Samberg Hires Zilkha**

8. In January 2001, Zilkha, a product manager at Microsoft, was seeking to enter the investment management field for the first time.

9. On January 18, 2001, he interviewed with Samberg in the hopes of getting a position with Pequot as an analyst.

10. On February 28, 2001, Samberg extended Zilkha an offer to work as a Vice President at Pequot, reporting directly to Samberg.

11. That night, Samberg emailed Zilkha confirming that he had sent out the offer letter. In the email, Samberg expressed the view that the technology market had declined too far and that the Pequot funds he was managing should purchase securities of Microsoft and another high tech company based on the new products they were introducing.

12. In the February 28, 2001 email to Zilkha, Samberg stated that while Pequot's analysts did a good job covering the other high-tech stocks,

i'm not as impressed with our research on msft. do you have any current views that could be helpful? Might as well pick your brain before you go on the payroll!!

13. Zilkha replied to Samberg by email the next day. Agreeing with Samberg, he said that he sensed that "the worst is over for Microsoft."

14. On or about March 4, 2001, Zilkha accepted Samberg's offer to work at Pequot and they determined that he would commence his employment on or about April 23, 2001.

15. On or about March 15, 2001, Samberg met with Zilkha at Pequot. On March 16, 2001, Samberg bought Microsoft call options on behalf of the Pequot funds and sold a corresponding number of put options at the same strike price. A call option gives the buyer an option to purchase from the seller 100 shares of stock at a strike price at any time up until expiration. A put option gives the buyer an option to assign to the seller 100 shares of stock at a strike price at any time up until expiration. By buying call options and selling a corresponding number of put options, an investor is able to reap essentially the same profit or loss as a stock owner would, but with a much smaller investment. This combination of option trades is known as a "long synthetic stock position."

16. Microsoft's earnings were set to be announced on April 19, 2001. In March and early April 2001, the belief of a number of analysts at Pequot and elsewhere was that Microsoft would fall short of Microsoft's previously announced earnings estimates for the Third Quarter.

17. On March 21, 2001, after receiving emails from a colleague that expressed dim views of Microsoft's earnings prospects, Samberg sold the Pequot funds' long position.

18. On April 2, 2001, Samberg received research that included the view of the Chief Technology Officer of a major investment bank lauding Microsoft's new Windows 2000 product.

19. On April 3 and April 5, 2001, Samberg took another long synthetic position in Microsoft options on behalf of the Pequot funds he managed.

**Zilkha Provides Samberg with Inside Information and Samberg Trades on It**

20. On Friday, April 6, 2001, while Zilkha was still employed by Microsoft, Samberg contacted Zilkha at his Microsoft email address. Samberg wrote:

I own some msft based on the win2000 cycle, despite recurring indications from knowledgeable people that the company will either *preannounce* or *take guidance down*. Any *tidbits* you might care to lob in would be appreciated

(emphasis added) (the "Tidbits Email").

21. On Saturday, April 7, 2001, Zilkha responded by email to the Tidbits Email, telling Samberg he would get back to him "on MSFT ASAP."

22. That night, using his Microsoft email address, Zilkha emailed two Microsoft colleagues explicitly asking for information about Microsoft's earnings results for the Third Quarter.

23. In an email to one of the colleagues, Zilkha asked, "Any ideas on how the quarter has shaped up for MSFT?"

24. Zilkha sent a separate email to his neighbor and colleague Mark Spain ("Spain"), a regional technology specialist in Microsoft's U.S. Sales and Services division. In the subject heading of the email, Zilkha asked, "Any visibility on the recent quarter?" In the body of the email, Zilkha further asked Spain directly, "Have you heard *whether we will miss estimates?* Any other info?" (emphasis added).

25. On April 8, 2001, Spain responded to Zilkha in an email, noting that Microsoft was "on track" to meet its earnings estimates:

march was the best march of record. made up the shortfall in us sub. w2k pro major contributor. on track for revised forecast (MYR).

26. On April 8 or April 9, 2001, Zilkha then communicated to Samberg Zilkha's understanding, based on the email Zilkha had received from Spain, that Microsoft would meet or beat its earnings estimates for the Third Quarter, information that had not yet been disclosed to the public. Zilkha conveyed this information with the intent of both benefiting Pequot and enhancing his stature with his new employer.

27. During the period from April 9 through April 11, 2001, Samberg purchased an additional 28,200 Microsoft call options and sold a corresponding number of put options at the same strike price for the Pequot funds that he managed.

28. On April 16, 2001, another portfolio manager at Pequot "sold short" 800,000 Microsoft shares in trades totaling almost \$50 million. A "short sale" is the sale of securities which the seller does not own or one consummated by the delivery of a security borrowed by, or for the account of, the seller. A seller makes a short sale in anticipation of a decline in the stock price.

29. The trades made by the other portfolio manager took place in Pequot funds that were not managed by Samberg, but Samberg was aware of the orders. Samberg then sought further comfort from Zilkha on the substantial position he had amassed in the company in anticipation of an increase in stock price. Minutes after the other portfolio manager placed the order to short Microsoft, Samberg emailed Zilkha, who was in Washington state, asking Zilkha for any "further [c]olor" on Zilkha's "alma mater" (*i.e.*, Microsoft).

30. Zilkha did not get back to Samberg until the evening of April 17, 2001, by which time Samberg had already (earlier that day) reduced the long Microsoft position held by the Pequot funds. Even reduced, Samberg's long Microsoft remained substantial, comprising 21,000 call options.

31. Zilkha, who had gone to Microsoft's offices on April 17, 2001, responded to Samberg that evening with an email stating that he had "heard that afternoon from the MSN finance controller that our CFO has been much more relaxed before this next earnings release than he has been in the last year. Augurs well."

32. On April 19, 2001, before the Microsoft earnings announcement, and by then having received Zilkha's reply, Samberg increased the Pequot funds' long position in Microsoft, buying 6,000 more call options and selling 6,000 put options on behalf of the Pequot funds. In addition, at Samberg's recommendation, a friend of Samberg's purchased 300,000 shares of Microsoft stock.

33. As a result of Samberg's trading activity, just prior to the Microsoft earnings announcement, the Pequot funds managed by Samberg owned 21,000 Microsoft

call options that had been purchased after Zilkha had first conveyed to Samberg material, nonpublic information. Each of the call option purchases reflected Samberg's expectation that Microsoft's stock price would increase.

**Microsoft Announces Earnings and Samberg Credits Zilkha with Pequot Profits**

34. On April 19, 2001, once the market had closed at 4:30 p.m. Eastern Standard Time, Microsoft announced its earnings results for the Third Quarter, which were better than its previously announced estimates. In particular, Microsoft announced revenue of \$6.46 billion and diluted earnings per share of \$.44, beating its estimates of \$6.3-\$6.4 billion in revenue and \$.42-\$.43 in diluted earnings per share.

35. By the end of the next trading day, Microsoft's stock price per share jumped 96 cents from \$68.04 at the close on April 19, 2001 to \$69 at the close on April 20, 2001.

36. The Microsoft securities that Samberg had purchased on behalf of Pequot funds on or after April 9, 2001 and held as of April 20, 2001 increased in value by approximately \$14,769,960. The gains by Pequot and Samberg flowing from their interests in the funds amounted to approximately \$4.1 million. The balance of the gains went to the benefit of the Pequot funds and their investors. In addition, the friend of Samberg's who had purchased Microsoft shares at Samberg's recommendation on April 19, 2001 had gains of \$372,060.

37. In the days following the Microsoft earnings announcement, Samberg credited Zilkha with his Microsoft trading and began recommending him to other colleagues at Pequot.

38. In an email sent the morning of April 20, for example, Samberg wrote to a Pequot analyst telling him, "david zilkha joins me Monday from Microsoft. You might want to talk to him about what he thinks is going on at the company."

39. Samberg then forwarded the email to Zilkha, with a note in which he attributed his successful Microsoft trading to Zilkha:

our tech group has a very dim view of pc demand, and consequently msft.  
in fact, they are short the stock in one account, while it is my largest long.  
*(I shouldn't say this, but you have probably paid for yourself already!)*  
[emphasis added.]

40. In another email, dated April 23, 2001, Samberg told two of his colleagues, "our new guy, david zilkha, is in ct today. Check him out. He's already got a great p&l based on his msft ;input."

41. Zilkha reported to work at Pequot on April 23, 2001, but technically remained an employee of Microsoft until May 7, 2001.



42. On April 24, 2001, Zilkha emailed Samberg with a list of companies he proposed to cover for Pequot. In the email, he also expressed a concern about overlapping with other Pequot analysts. Samberg responded with an email stating, in part, "do not worry over every little thing – just get to know the companies you listed, and tell me what to do with my msft position, which has been so successful already thanks to your help."

43. Zilkha also later received a complimentary email from a managing director at Pequot, who stated, "I am sitting here with 'the great one' aka art [Samberg]; who says we've made more money in msft in the last month than in the entire seven years before that!"

44. On or about September 25, 2001, Samberg told Zilkha that Zilkha's employment at Pequot was going to be terminated, but that he could continue to work at Pequot for a short period as he looked for a new job.

45. Zilkha's employment at Pequot was terminated on or about November 16, 2001.

**Zilkha's Fiduciary Duty to Keep Confidential All  
Material, Nonpublic Information about Microsoft**

46. Zilkha knew that as a Microsoft employee, he had a duty to keep confidential all material, nonpublic information about Microsoft and that it was illegal to convey such information to Samberg.

47. Microsoft's insider trading policy, in effect during the relevant period and to which Zilkha was subject, made it clear that Zilkha could be held liable for tipping others to trade on inside information:

Just as you may not trade in the stock of Microsoft when you know material nonpublic information, you may not disclose such information to any third party who then trades in Microsoft stock. This is considered illegal "tipping" and you could be held liable even if you yourself did not trade any Microsoft shares. You could also be held liable if you are found to have recommended to another that he or she buy or sell Microsoft stock, even if you do not disclose the material nonpublic information.

48. The Microsoft insider trading policy listed "fiscal quarter . . . financial results" among examples of material information and stated that "there is a considerable risk you will pay dearly if you engage in insider trading in Microsoft stock," listing some of the possible civil and criminal sanctions to which violators are subject.

49. Zilkha had also signed an employee agreement that expressly prohibited him from disclosing confidential information about Microsoft to persons outside of the company.

### Zilkha's Concealment of the Insider Trading

50. In the Spring of 2005, the Commission staff began investigating trading by Pequot in Microsoft securities.

51. In an effort to ascertain whether the Zilkha, Samberg and Pequot had engaged in insider trading, the Commission staff interviewed Zilkha and subpoenaed all relevant documents from him.

52. Despite these efforts, however, Zilkha concealed the facts that 1) on or about April 8, 2001, he had received material, nonpublic information indicating that Microsoft would meet or beat its earnings estimates for the Third Quarter and 2) he had then conveyed to Samberg his understanding about Microsoft's Third Quarter earnings based on the information Zilkha had received from Spain.

53. Pursuant to subpoenas issued by the Commission staff, Zilkha had been obligated to produce all documents, including emails, concerning Microsoft. However, Zilkha never produced or disclosed the contents of his April 7, 2001 email to Spain and Spain's April 8, 2001 response (collectively the "Spain Emails") to the Commission staff.

54. During an interview with the Commission staff in December 2005, Zilkha was specifically asked about Samberg's Tidbits Email. Zilkha suggested that he had not contacted anyone at Microsoft to get information in response to the email, that he had no new information about Microsoft to provide Samberg, and that he did not recall responding to Samberg or otherwise giving him any additional information about Microsoft.

55. In addition, in response to questions about his contacts at Microsoft during this and other interviews with government agents during 2005 and 2006, Zilkha listed a number of individuals but never mentioned Spain's name in any context. Zilkha also never disclosed to the Commission staff the existence or contents of the Spain Emails during any of these interviews.

56. In November 2006, the Commission staff's initial investigation was closed after Zilkha failed to produce evidence that he had material, nonpublic information about Microsoft on or about April 8, 2001, before he communicated to Samberg his understanding that Microsoft would meet or beat its earnings estimates for the Third Quarter.

57. The Commission staff first received direct evidence that Zilkha had material, nonpublic information about Microsoft in January 2009, when the staff was provided copies of the Spain Emails, which had been located on a computer hard drive that was then in the possession of Zilkha's ex-wife.

58. In or about January 2007, once the staff's initial investigation of Pequot's trading in Microsoft securities was closed, Zilkha prepared a draft complaint of an employment law claim against Pequot and Samberg. In it, among other things, he admitted

that he had “conveyed to Samberg his view that MSFT would meet or exceed its earnings estimates.”

59. Zilkha eventually settled his claim with Pequot and Samberg, which was kept confidential until Zilkha was compelled to disclose it during divorce proceedings with his ex-wife. The claim was then made public in news articles published in December 2008.

**Zilkha Invokes His Right against Self-Incrimination  
and Declines to Answer Questions of Commission Staff**

60. On May 27, 2009, in response to questions from Commission staff regarding trading by Samberg and Pequot in Microsoft securities, as well as Zilkha’s failure to produce the Spain Emails, Zilkha invoked his Fifth Amendment right against self-incrimination and declined to answer.

**E. VIOLATIONS**

61. As set forth above, Zilkha conveyed material, nonpublic information about Microsoft’s earnings for the quarter ended March 31, 2001 to Samberg, at a time when he was under a duty to refrain from doing so. Accordingly, Zilkha 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.

**III.**

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate and in the public interest that cease-and-desist proceedings be instituted pursuant to Section 21C of the Exchange Act, and public administrative proceedings be instituted pursuant to Section 203(f) of the Advisers Act and Section 9(b) of the ICA to determine:

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

B. Whether, pursuant to Section 21C of the Exchange Act, Respondent should be ordered to cease and desist from committing or causing violations of and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

C. Whether, pursuant to Section 21C(e) of the Exchange Act, 203(j) of the Advisers Act, and Section 9(e) of the ICA, Respondent should be ordered to pay disgorgement and prejudgment interest;

D. Whether, pursuant to Section 203(i) of the Advisers Act and Section 9(d) of the ICA, to impose a civil penalty as a result of Respondent’s willful violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and

E. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 203(f) of the Advisers Act and Section 9(b) of the ICA.

#### IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

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

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

This Order shall be served forthwith upon Respondent personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

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

By the Commission.

*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. 62191 / May 28, 2010

ADMINISTRATIVE PROCEEDING  
File No. 3-13915

In the Matter of

GABRIEL PAREDES,

Respondent.

ORDER INSTITUTING  
ADMINISTRATIVE PROCEEDINGS  
PURSUANT 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 Gabriel Paredes ("Paredes" or the "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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### III.

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

1. Paredes, age 32, is a resident of Upland, California. Paredes became a World Financial Group, Inc. associate in July 2004. Paredes became a registered representative with World Group Securities, Inc., a broker/dealer registered with the Commission, in August 2005. Paredes resigned from both WFG and WGS in April 2008. Paredes has no prior disciplinary history with the Commission or any state or self-regulatory organization.

2. On April 21, 2010, a final judgment was entered by consent against Paredes, permanently restraining and enjoining him from violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and from aiding and abetting future violations of Section 17(a) of the Exchange Act and Rules 17a-3(a)(6) and 17a-3(a)(17) thereunder in the civil action entitled Securities and Exchange Commission v. Ainsworth, et al., Civil Action Number EDCV08-1350 VAP (OPx), in the United States District Court for the Central District of California.

3. The Commission's complaint alleged that Paredes' recommendation to customers to purchase a Variable Universal Life insurance policy was unsuitable.

### IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Paredes be, and hereby is suspended from association with any broker or dealer for a period of 90 days.

By the Commission.

Elizabeth M. Murphy  
Secretary

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